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IN THE

Supreme Court of the United States

October Term, 1972

No. 72-611

Marvin Goodson and William E. Hannam,

Petitioners,

vs.

Allen V. C. Davis, Custom Component Switches, Inc., Thomas C. May, Glen A. Berry, Don Griffith, Cal Casey and Robert Miller,

Respondents.

VOLUME I.

Petition for Writ of Certiorari to the Court of Appeal for the State of California, Second Appellate District, Division Five.

JOSEPH A. BALL,
450 North Roxbury Drive,
Beverly Hills, Calif. 90210,
(213) 278-1960,
Attorney for Petitioners.

BALL, HUNT, HART, BROWN & BAERWITZ,
JOHN R. McDONOUGH,
450 North Roxbury Drive,
Beverly Hills, Calif. 90210,
(213) 278-1960,

O'MELVENY & MYERS,
PHILIP F. WESTBROOK, JR.,
611 West 6th Street,
Los Angeles, Calif. 90017,
(213) 620-1120,
Of Counsel.

Parker & Son, Inc., Law Printers, Los Angeles. Phone 724-6622

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Allen V. C. Davis, Custom Component Switches, Inc., Thomas C. May, Glen A. Berry, Don Griffith, Cal Casey and Robert Miller,
Respondents.

Petition for Writ of Certiorari to the Court of Appeal for the State of California, Second Appellate District, Division Five.

Marvin Goodson ("Goodson") and William E. Hannam ("Hannam"), defendants and appellants below, respectfully petition for a writ of certiorari to review the judgment of the Court of Appeal for the State of California, Second Appellate District, Division Five, in *Allen V. C. Davis v. Marvin Goodson and William E. Hannam, et al.,* Case No. 37319 in said court.

A. OPINION OF THE CALIFORNIA COURT OF APPEAL.

The only opinion below is that of the California Court of Appeal. It was not certified for publication and, hence, was not reported. A copy including its judgment is separately filed as Appendix I to this petition, as authorized by Supreme Court Rule 23(1)(i) and (j).*

B. JURISDICTION OF THIS COURT.

The opinion of the California Court of Appeal was filed on May 23, 1972. The finality of that judgment was suspended first by a timely petition for rehearing in that court, which was filed on June 7 and denied on June 20, 1972, and then by a timely petition for hearing in the Supreme Court of California, which was filed on July 3 and denied on July 19, 1972.**

This Court has jurisdiction by virtue of the provisions of 28 U.S.C. § 1257(3).

C. QUESTIONS PRESENTED FOR REVIEW.

This petition presents for review the following questions:

1. Whether paramount federal law and policy require reversal of a state court judgment which specifically enforces a conspiracy to defraud the United States under the federal Renegotiation Act and the Internal Revenue Code.

2. Whether the due process clause of the Fourteenth Amendment requires reversal of a state court judgment:

    a. Where, by reason of defendants' exposure of the trial court's judicial misconduct during trial, it became so biased and prejudiced against defendants that it was incapable of according them a fair determination and

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*The judgment of the trial court is annexed hereto as Appendix II. Supreme Court Rule 23(1)(j).

**The order of the Court of Appeal denying rehearing and the order of the Supreme Court of California denying hearing are annexed hereto as Appendix III. Supreme Court Rule 23(1)(j).

b. Where the state appellate court held that the trial court may have been incapable of according the parties a fair determination but nevertheless affirmed the judgment in substantial part on the basis of state rules of appellate procedure giving virtually conclusive weight to a trial court's findings of fact.

These questions were decided by the courts below in a way not in accord with applicable decisions of this Court. Supreme Court Rule 19(1)(a).

D. CONSTITUTIONAL PROVISIONS, STATUTES AND REGULATIONS.

This case involves the following constitutional provisions, statutes and regulations:

1. Various sections of the Renegotiation Act, 50 U.S.C. Appx. §§ 1212(a), 1213(e), (g), (j) and (k), 1215(e)(1) and 1215(f)(1), and the regulations of the Renegotiation Board, 32 C.F.R. §§ 1452.6, 1458.6 and 1499.1-5.

2. Various sections of the Internal Revenue Code, 26 U.S.C. §§ 267(b) and (c), 1235, 7201, 7206(1) and 7207, and Treasury Regulations, 26 C.F.R. §§ 1.267 and 1.1235.

3. The due process clause of the Fourteenth Amendment to the Constitution of the United States which provides ". . . nor shall any State deprive any person of life, liberty, or property, without due process of law. . . ."

Because of its length, the pertinent text of the sections of the statutes and regulations involved is set forth in the annexed Appendix IV to this petition, as authorized by Supreme Court Rule 23(1)(d).

E. STATEMENT OF THE CASE.

Petitioners Goodson and Hannam are attorneys and certified public accountants. This case involves a plan which Goodson and Hannam developed for respondent Davis to eliminate or minimize his obligations and liabilities under the Federal Renegotiation Act and to minimize his federal income taxes. The Plan has been referred to throughout this case as the "Custom Plan."

There are in the record two versions of the Custom Plan. A version which would be lawful under the federal renegotiation and tax laws was presented in the testimony of Goodson and Hannam, their experts, other witnesses, and by documentary evidence. That version was corroborated by Davis in sworn deposition testimony and affidavits in other litigation, in representations to the business community and his other professional advisors, in nine years of consistent conduct, and, both before and after the commencement of the litigation, in claiming and receiving renegotiation and tax benefits obtainable only under the lawful version of the Plan.

A completely different version of the Custom Plan was told only by Davis at trial—a tale of an out and out conspiracy to hoodwink the Renegotiation Board and Internal Revenue Service for the purpose of defrauding the United States of millions of dollars of excess profits and tax revenues payable to the U.S. Treasury. Incredibly, Davis' version was accepted by the trial court and specifically enforced by the judgment against Goodson and Hannam in this case, which was affirmed by the Court of Appeal.

Division Two of the Court of Appeal, in a preliminary proceeding pertaining to relief pending appeal, had no difficulty in perceiving both the essence and the illegality of Davis' version of the Custom Plan, *as set forth in the findings of the trial court,* when it summarized them as follows:

> "It appears that in 1956 plaintiff Davis was the owner of three inventions on which patent applications were pending, and he was engaged in manufacturing devices relating to these inventions, doing business in corporate form as Hydra-Electric.* In 1957 a plan was devised by Goodson and Hannam, attorneys and certified public accountants, for Davis to transfer a half interest in the pending patents and a half interest in the manufacturing business to a separate corporate entity *in order to secure tax advantages to Davis and in order to create an ostensible second source of supply for Davis' products and thereby forestall renegotiation claims by the government.* The separate corporate entity would compensate Davis for the transfer of property and business by the payment of royalties. The controlling interest in the new business would be held in the names of Goodson and Hannam, and a third party, May, would be brought into the new business as a supplier of capital and minority shareholder. *The plan contemplated the use of Goodson and Hannam as dummy shareholders to hold the controlling interest in the business for Davis pursuant to an oral agreement under which*

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*Davis' wholly owned Hydra-Electric corporations are referred to herein as "Hydra" for convenience.

they would transfer the shares and controlling interest in the business to Davis on request or make such changes in the form of the business as he should direct.

"Pursuant to this plan Davis in 1957 transferred a half interest in his patent applications and business and half his pending orders and contracts to a separate entity—Custom—in which he had no legal ownership and which on the surface was operated as an independent competitive entity obligated to pay 65 percent of its net profits to Davis as royalties. *The reason for the transfer was to secure favorable tax benefits for Davis and a favorable renegotiation posture for Davis in his dealings with the government.* (Although the findings do not spell out this feature of the case in detail, it appears that an ostensibly competitive second source of supply was created for products sold by Davis to the government and *the beneficial ownership by Davis of the ostensibly competitive second source of supply was concealed from the government to forestall a government claim of a single source of supply and consequent renegotiation of the prices paid by the government to Davis for his products.*) The new business prospered, and for over eight years Goodson and Hannam remained in charge. During this period Custom paid Davis royalties approximating $3,400,000. In 1965 Davis asked Goodson and Hannam to transfer the controlling shares back to him pursuant to their oral promise to do so. They refused, and this suit followed." (*Davis v. Custom Component Switches, Inc.*, 13 Cal.App.3d 21, 24-25, 91 Cal.Rptr. 181 (1970) (emphasis added).)

Division Two's perception of the essential nature of Davis' version of the Custom Plan was based on the findings of the trial court, principally Finding 26(g):

> "26. In order to induce Davis to enter into such agreements, Goodson and Hannam made the following representations to Davis:
>
> "(g) In the event of any change of circumstances which made the arrangement unsatisfactory to Davis for any reason; or in the event any other arrangement might become available in the light of future events which was more beneficial to Davis, Goodson, Hannam, Custom and May would willingly revise the arrangement to whatever extent might be necessary for Davis' benefit, including putting Custom out of business; and in that connection, Goodson and Hannam would so arrange the transaction that all of Custom's assets would be turned over to Davis, except for such amounts as might be required to pay its just obligations and to return to them and May a fair compensation for their services and advances to Custom."

This basic finding was not disturbed by Division Five of the Court of Appeal.

The Custom Plan found by the trial court bears little resemblance to the lawful Custom Plan described by all of the witnesses except Davis as follows:

Early in 1957, it had become apparent that Hydra was going to have well over $1,000,000 in sales in that fiscal year with the result that its 1957 profits would be subject to federal renegotiation. Hydra was realizing a net profit of 35% to 40% of sales. If Davis were required to file renegotiation reports, the Renegotiation Board would have determined that these profits were excessive and reduced them to not more than 12% to 15%. Moreover, the Renegotiation Board would have communicated its determination to government contractors buying from Hydra, thus permanently curtailing its earning power.

To avoid this result, Goodson and Hannam advised Davis to make an absolute sale of an undivided one-half interest in his patents to a completely separate and independent company, Custom. Payments to Davis by Custom of a percentage of net profits (65%) on Custom's sales of devices covered by the patents would not be subject to renegotiation [50 U.S.C. § 1213(g)(2)]. An additional benefit of the Plan was that Custom's patent payments to Davis would be taxable to Davis at capital gain rates [26 U.S.C. § 1235].

Goodson and Hannam emphasized to Davis that he could have no interest in or control over Custom because the renegotiation act provided that companies under "common control" were, in fact, to be treated as one. [50 U.S.C. Appx. § 1215(f)(1)]. They also emphasized to Davis that from both a renegotiation and tax point of view it was essential that the transaction have substance; if Davis owned Custom in the sense that ultimately he would receive all of the benefits of ownership and in addition receive currently 65% of its net profits, the transaction would be formalistic and would lack substance. Goodson and Hannam obtained favorable prospective rulings from the Renegotiation Board and the Internal Revenue Service with respect to this Plan.

Goodson and Hannam agreed to and did establish Custom.* They were issued 51% of Custom's stock

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*In fact there were three Custom Companies but only one surviving for more than a few years. The singular form is used for convenience.

(later their combined interest was increased to 60.66% of the stock.) Because Hydra's growing sales would otherwise have exceeded $1,000,000 in 1957, Davis assisted Custom to become established by providing substantial start-up help and assisting it in obtaining initial orders, a process facilitated by the desire of prime contractors to have a "second source" of supply. Custom thereafter operated independently of Davis and Hydra. From 1957 until 1966, the year this action was commenced, Custom made patent payments in excess of $3,000,000 to Davis.**

Under the lawful version of the Custom Plan, recommended to Davis by Goodson and Hannam, Davis had no interest in Custom other than the right to patent payments of 65% of Custom's net profits. That plan qualified for the renegotiation and tax benefits which Davis obtained. Contrariwise, Davis was not entitled to those benefits if, as he testified in this case (contrary to his earlier testimony), he was the "real owner of Custom", had the "total interest" in Custom, and always owned Custom "pure and simple, lock, stock and barrel".

As we show, *infra* pp. 14-20, if Davis was the beneficial owner of Custom, he was required to file annual reports with the Renegotiation Board showing Custom's patent payments to him as renegotiable receipts under the Renegotiation Act. In addition, Hydra was required to report that Hydra, Davis and Custom were under common control and disclose the renegotiable receipts of Davis and Custom as well as those of Hydra. Under the Internal Revenue Code Davis was required to report Custom's patent payments to him as ordinary income. Yet before and even after this litiga-

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**To date, Davis has received patent payments of approximately $7,000,000.

tion commenced in 1966 (1) Davis personally did not file any report with the Renegotiation Board; (2) Hydra filed annual reports with the Renegotiation Board *signed by Davis,* which affirmatively represented that Hydra was not under common control with any other person; and (3) Davis reported the patent payments which he received from Custom as capital gains instead of ordinary income in all of his personal income tax returns. Through these combined actions, Davis defrauded the United States Treasury of millions of dollars of excess profits payments and income tax revenue.*

Davis' own testimony, statements and conduct over the years make it clear that Davis could not have believed that he could have an ownership interest in Custom if the Plan were lawfully to achieve its renegotiation and tax objectives. For example, in a patent infringement action against Davis, Hydra and Custom in 1958 Davis was asked, on deposition, if he had ever had any interest in Custom and replied, "None whatsoever." By affidavit in that case, Davis stated that Custom "is a separate corporation and not connected in any way with affiant or the corporations of which he is president." And, indeed, Davis admitted in this case that he had been told by Goodson and Hannam in 1957 that he could not own any stock in Custom and

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*Davis' actions were, of course, criminal acts *vis-a-vis* the United States. False or misleading reports to the Renegotiation Board are proscribed by United States Code, Title 50, Appx. § 1215(e)(1); false returns to the Internal Revenue Service are proscribed by §§ 7201, 7206(1) and 7207 of the Internal Revenue Code. Moreover, any false statement in a tax return is an indictable offense, if the false statement would have a tendency to impede the Internal Revenue Service in its role of auditing and investigating returns. *United States v. Di Varco, Inc.*, 72-1 U.S.T.C. 9470, 72 CR 177 (6/6/72) (N.D. Ill. 1972).

that Custom "couldn't be a sham company." The conclusion is inescapable that Davis knew at all times that he could not claim the renegotiation and tax benefits of the Custom Plan if he were the "real owner" of Custom.

Despite the fact that Davis' version of the Custom Plan was a fraud on the Federal Government from which he had realized millions of dollars of undeserved renegotiation and tax benefits and that the primary means by which the fraud was perpetrated was his filing of consciously false renegotiation and tax returns, the trial court accepted Davis' version of the Plan and entered a judgment specifically enforcing his rights under the Plan against his alleged co-conspirators. The judgment, *inter alia,* imposed a constructive trust in Davis' favor on the stock owned by Goodson and Hannam in Custom and awarded Davis compensatory damages of $1,232,192.00. The purpose and effect of this judgment was to hold that Davis had been the beneficial owner from the beginning of the Custom stock held by Goodson and Hannam and to give him the full economic benefit of that ownership, retroactively as well as prospectively.

The trial court's acceptance and enforcement of Davis' version of the Custom Plan can be understood only in the light of the bias and prejudice the trial court displayed after defendants exposed its misconduct during trial. On June 3, 1970, the trial judge initiated nocturnal telephone conversations with counsel for Davis and one defendant. In open session the following morning, the trial court purported to make a full disclosure of those conversations, indicating that they did not involve matters going to the merits. Counsel for Goodson and Hannam then proved, without contradiction, that in fact the trial court had discussed the case on the merits and stated how it was going to rule, conduct which the Court of Appeal characterized as "a flaw in the operation of due process."* (Appendix I, p. 43.) Both before and after this proof, counsel for Goodson and Hannam moved for a mistrial upon the ground of irregularity in the proceedings of the court, pointing out that there were important matters concerning Goodson and Hannam pending before the court. Both motions were summarily denied.

Thereafter, as Division Five of the Court of Appeal stated:

> "It is clear from the record that the trial court's judicial mood was affected by the telephone incident and its aftermath and the justifiable shock displayed by counsel. It became sensitive and self-conscious as evidenced by a series or remarks it made not only at the time but intermittently thereafter.* We refrain from quoting or characterizing them. Those concerned are thoroughly familiar with them. We simply point out that they suggest that the trial court was counter reacting to what it realized had been ill advised communications. It may not have been in the judicial frame of mind to afford the parties a fair determination. The unfortunate incident and its immediate aftermath were not conducive to a calm and deliberate adjudication. Determination of an issue without a fair hearing may constitute a denial of due process and reversible error *per se*. . . ." (Appendix I, p. 44.)

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*Goodson and Hannam were principal targets of the unjudicial remarks of the trial court referred to in the opinion of the Court of Appeal.

In the atmosphere thus described by the Court of Appeal, the trial court adopted the voluminous findings proposed by Davis' counsel *verbatim*, except for one minor change approved by Davis' counsel, without so much as a hearing, despite defendants' request therefor. The Court of Appeal pointed out that a substantial number of those findings were not "fully supported," were "extravagantly put" or lacked "integrity." (Appendix I, pp. 6-7, n.2.) or were not supported at all. (Appendix I, pp. 56, 59-66.)

The Court of Appeal reversed on the ground of the trial court's apparent incapacity to make a fair determination on behalf of defendant May with respect to a major issue. Moreover, the appellate court, *on its own motion*, adduced the trial court's "judicial interregnum" as a reason for its decision to reverse the judgment insofar as it was adverse to Davis in respect of the defendant employees' stock purchase rights (Appendix I, pp. 48-49)—even though the court itself noted that "For obvious reasons, Davis does not assert [as a ground of appeal] a lack of due process or of fair hearing or semblance thereof". (Appendix I, p. 48.) Yet, the court left untouched virtually all of the judgment of the trial court against Goodson and Hannam, the principal victims of the trial court's bias and prejudice.

Even though it had held that the trial court may not have been in a judicial frame of mind to afford the parties a fair determination, the Court of Appeal gave almost conclusive weight to the trial court's findings of fact, thus subordinating due process of law to state rules of appellate procedure. Moreover, the Court of Appeal failed to meet squarely petitioners' contention that paramount federal law and policy required reversal of the trial court judgment because it specifically enforced a conspiracy to defraud the United States under the federal Renegotiation Act and the Internal Revenue Code.* The Court of Appeal's decision does not accord with applicable decisions of this Court.

F. REASONS FOR ALLOWANCE OF THE WRIT.

1. Paramount Federal Law and Policy Require Reversal of a State Court Judgment Which Specifically Enforces a Conspiracy to Defraud the United States Under the Federal Renegotiation Act and the Internal Revenue Code.

Under the Custom Plan as found by the California courts, Davis was the beneficial owner of Custom. Therefore, the Custom Plan was necessarily a scheme to defraud the federal government, effectuated primarily by means of plaintiff Davis' failure to file required renegotiation reports on his own behalf, Hydra's filing of false renegotiation reports and Davis' filing of false income tax returns in 1957 and thereafter.

a. Davis' Fraud on the Federal Renegotiation Board.

The Renegotiation Act of 1951 (the "Act") is a complex statute designed to prevent Government prime contractors or subcontractors from earning excessive profits on sales to the U. S. Government or its prime contractors, by requiring such excessive profits to be refunded to the Government. It established a Renegotiation Board (the "Board") to administer the Act.

Under the Act a contractor whose annual gross receipts from such sales exceed $1 million dollars a year must file a renegotiation report of those receipts with the Board. An inquiry is then made by the Board to see whether he has made an excessive profit on those sales. If the contractor has sales of less than $1 million dollars he must file a Statement of Nonapplicability with the Board.

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*Because of length, the stage in the proceedings at which and the manner and method in which the federal questions sought to be reviewed were raised is set forth in the annexed Appendix V. Supreme Court Rule 23(1)(f).

In filing either form of report, the contractor must state whether any other persons are under "common control" (*infra*, pp. 16, 17) with him, name each such person, and report his renegotiable receipts. These receipts are then aggregated with those of the contractor for the purpose of determining whether the $1 million dollar statutory minimum is met by all of them as a group. If the statutory minimum is met by the group, each member is subject to renegotiation. [50 U.S.C. App. § 1215(e)(1) and 1215(f)(1).]

Not unnaturally, companies having renegotiable receipts try to find legally acceptable means of keeping those receipts below the $1 million dollar minimum. Indeed, it was precisely because Hydra's renegotiable receipts were going to exceed $1,000,000 in 1957 that the Custom Plan came about.

Because Davis owned all of the stock of Hydra, Davis and Hydra were in common control. Therefore, in designing the Custom Plan it was necessary to work out arrangements that would not only keep Hydra's renegotiable receipts below $1,000,000, but would also (1) avoid having Custom's patent payments to Davis treated as renegotiable receipts in his hands, and (2) avoid Davis' having any interest in or relationship to Custom that would put Custom in common control with Davis and Hydra.

The lawful version of the Custom Plan fully met both of these requirements with the result that Custom's payments to Davis would not be renegotiable receipts and the receipts of Davis, Hydra and Custom would not be aggregated to determine whether they exceeded the statutory minimum. This was because, under that version of the Plan, Davis had no ownership interest in or other relationship with Custom that put Davis, Hydra and Custom in common control and Davis made a bona fide sale of an undivided interest in his patent to Custom.

Under the Davis version of the Custom Plan adopted by the California courts, the opposite was true. Davis was under common control with Custom and the Davis-Custom transaction was not a bona fide sale. As a result, Custom's payments to Davis were renegotiable receipts in his hands and Davis, Hydra and Custom were all under common control with each other.

(i) *Common Control*

"Common control" is not defined in the Act but is defined in the regulations which provide in pertinent part:

> "§ 1458.6 *Tests of 'control.'* For the purposes of § 105(f) of the act, in determining whether the contractor controls or is controlled by or under common control with another person, the following principles will be followed:
>
> ". . .
>
> "(b) *Individual Control.* An individual who owns more than 50% of the voting stock of a corporation controls the corporation and also controls all corporations controlled by the corporation.

> "(d) *Joint Venture Control.* A joint venturer who is entitled to more than 50% of the joint venture controls the joint venture.
>
> "(e) *Other cases.* Actual control is a question of fact. Even though the foregoing conditions do not exist, the Board may determine that actual control exists." (emphasis added.)

During the years under consideration, Davis controlled Hydra because Davis owned 100% of Hydra's stock. He also controlled Custom under Section 1458.6 (b) because he was the beneficial owner of more than 50% of Custom's stock.* Because of these relationships, Davis, Hydra and Custom were all under common control with each other.

(ii) *The "bona fide sale" requirement.*

The requirement that the Davis-Custom transaction be a bona fide sale of the undivided patent interests to make Custom's patent payments to Davis nonrenegotiable receipts in his hands arises primarily out of Section 105(f) of the Act, which provides that receipts from subcontracts are renegotiable if the requirements of renegotiation are otherwise met. [50 U.S.C. Appx. § 1215(f).] "Subcontract" is defined in Section 103(g) of the Act, in part, as:

> "(2) any contract or arrangement covering the right to use any patented or secret method, formula, or device for the performance of a contract or a subcontract. . . ."
>
> [50 U.S.C. App. § 1213(g).]

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*Moreover, Davis controlled Custom within the meaning of Section 1458.6(e) when Davis' right to receive 65% of Custom's net profits in addition to his beneficial ownership of more than 50% of Custom's stock is taken into consideration.

However, the regulations of the Renegotiation Board in Section 1499.1-5 provide that the sale of a patent does not constitute a subcontract within the meaning of the Renegotiation Act. Under these provisions anything less than a bona fide sale of an undivided interest in Davis' patents to Custom would have been no more than a "contract or arrangement covering the right to use" the patent. Thus, it would have been a subcontract within the meaning of Section 103(g)(2), making the patent payments renegotiable receipts in Davis' hands.

A transfer by Davis, in his individual capacity, of an undivided interest in his patents to a corporation in which he owned a majority stock interest, for a purchase price of 65% of the buyer's net profits—*i.e.*, a "sale" by Davis to Davis for a consideration equal to well over 80% of the earning power of the asset over its useful life—would not constitute a bona fide sale within the meaning of the renegotiation statute and regulations. The result was not changed by having the bare legal title to Custom's stock held by Goodson and Hannam under an agreement that Davis was its beneficial owner.

Because Davis, Hydra and Custom were in common control with each other, and because the Davis-Custom transaction was not a bona fide sale, Davis should have filed a report with the Renegotiation Board in 1957 and each year thereafter reporting the patent payments made by Custom to him as renegotiable receipts and also reporting his common control relationship with both Hydra and Custom. In addition, Hydra should have reported in the Renegotiation Board reports it filed in 1957 and each year thereafter that it had a common control relationship with both Davis and Custom. None of these reports were made. Moreover, Hydra's reports, *each of which was signed by Davis*, affirmatively represented that Hydra was *not* in common control with any other person. By this means, Davis defrauded the United States of millions of dollars of excess profits that should have been paid into the U. S. Treasury.

b. Davis' Fraud on the Internal Revenue Service.

A *bona fide* sale of Davis' patent rights was also essential to qualify the Custom Plan for the tax benefits which it was designed to achieve for Davis. Subsection (a) of Section 1235 of the Internal Revenue Code provides that a sale by any holder of all substantial rights to a patent, or of an undivided interest therein which includes a part of all such rights, shall be considered the sale or exchange of a capital asset held for more than six months (26 U.S.C. § 1235(a).), the payments made to the holder thus qualifying for capital gains tax treatment. However, Subsection (d) of Section 1235 provides that subsection (a) shall not apply to any transfer between persons specified in any of the paragraphs of Section 267(b). (26 U.S.C §§ 1235(d), 267(b).) Among the persons so specified are:

> "An individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual." (26 U.S.C. § 267(b)(2).)*

Under Davis' version of the Custom Plan, he was the beneficial owner of more than 50% of the outstanding stock of Custom. Hence, *as a matter of law*, he could not lawfully claim the benefit of Section 1235 in his income tax returns, but he nevertheless did so each year from 1957 to the time of trial. Through these fraudulent tax returns, Davis defrauded the United States of millions of dollars of tax revenue that should have been paid into the U. S. Treasury.

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*In 1958, the 50% figure was changed to 25%. (26 U.S.C. § 1235(d).)

c. The Decision Below Is Not in Accord With Applicable Decisions of This Court.

Division Five of the Court of Appeal acknowledged that the Renegotiation Board ". . . was entitled to an explanation of the Custom Plan on the thesis that Goodson and Hannam's stock ownership, the duration of the royalty obligation, the royalty percentages, and the collateral assurance of means for reverter, taken together, did pose a possibility of common control". (Appendix I, p. 28.) However, the appellate court concluded that it would not "enter [the] alien field" of federal renegotiation law to determine whether the Board would have found common control if such disclosure had been made. (Appendix I, p. 29.) This failure to determine whether Davis' fraud on the Federal Government bars him from relief was clearly erroneous under *Anderson v. Carkins*, 135 U.S. 483, 10 S. Ct. 905 (1890). There, plaintiff brought an action in the state trial court in Nebraska for specific performance of a contract to convey a parcel of land. The defense was that the contract was against public policy because it violated the federal homestead laws. The Nebraska courts entered a decree for plaintiff and, on writ of error, the United States Supreme Court reversed, saying:

> "There can be no question that this contract contemplated perjury on the part of Anderson [*vis-a-vis* the Federal Government], and was designed to thwart the policy of the government in

> the homestead laws, to secure for the benefit of the homesteader the exclusive benefit of his homestead right. Such a contract is against public policy, and will not be enforced in a court of equity. Such being the scope and purpose of the federal statutes, *it is not within the power of a state, directly or indirectly, to nullify or set them at naught*. [Emphasis added.]
>
> * * *
>
> The Supreme Court of Nebraska, recognizing the general rule as to the invalidity of contracts against public policy, seemed to think that the parties were not *in pari delicto;* but we are unable to see any distinction in moral *status* between the man who contracts for the perjury of another and the one who contracts to commit such perjury. The fact that the former party may have parted with money or valuable property does not change the quality of his action, or give him higher claim to the consideration of a court of equity. So it results that the federal question in this case was not rightly decided by the state court, and no other question appears, which, rightly decided, upholds its decree. The case therefore must be reversed, and remanded to the supreme court of the state of Nebraska, for further proceedings in accordance with this opinion; and it is so ordered." (135 U.S. 483 at 490-491.)"

The Court of Appeal purported to justify its failure to decide the federal questions raised by defendants by saying that it would "explicate the subordinate involvement of Davis" because of the "more significant value . . . of the high professional fiduciary duty which an attorney owes to his client," citing *Clark v. Millsap,* 197 Cal. 765 (1926). (Appendix I, p. 29.) *Clark* held, on the particular facts there involved, that a client who had conveyed property to her attorney in fraud of creditors could sue the attorney to get the property back. However, the principle of state law there announced is not binding on this Court in the present case, which involves the application of paramount federal law and policy to determine whether an active participant in a scheme to defraud the federal government may sue his alleged co-conspirators. *Anderson v. Carkins, supra.*

In any event, Davis' situation is entirely different from that of Mrs. Clark. Hers was a relatively passive role, whereas Davis was an active participant in the fraudulent scheme to defraud the federal government in this case and the sole recipient of the millions of dollars of renegotiation and tax benefits which were realized through the fraud. Moreover, the principal instrument through which the fraud was accomplished was Davis' perjury in filing false renegotiation reports and tax returns. Nor may Davis deny *scienter* on the ground that he relied upon Goodson and Hannam's advice in filing false renegotiation reports and tax returns. From 1960 forward, Hydra's renegotiation reports and tax returns were prepared by Hyman Glass, Davis' certified public accountant, without guidance from or consultation with Goodson and Hannam. Even more important, Hydra's renegotiation reports continued to assert no "common control" down to the time of trial in 1970, even though Davis had sued Goodson and Hannam in 1966, thus completely severing his relationship with them.

For all of the foregoing reasons, the California courts were wholly unwarranted in granting specific performance of the conspiracy to defraud the United States upon which Davis based his claims in this action.

2. The Due Process Clause of the Fourteenth Amendment Requires Reversal of the State Court Judgment.

a. Denial of a Fair Determination in Derogation of the Due Process Clause.

On June 3, 1970, after extended argument on various matters, the trial court stated that it planned to make a ruling the next morning as to the matters that were then before it. Instead, the trial court disclosed its ruling in nocturnal telephone calls that evening to only some of counsel. On June 4, 1970, in open session, the trial court stated that it wished to make a "full disclosure as to what has taken place since court adjourned yesterday." That court then said that it had first called Davis' counsel and asked about dates on certain exhibits and discussed possible receivers for Custom and then had called Smith, counsel for Custom, and told him the essence of what it had told Davis' counsel. The court concluded: ". . that, in essence, is what happened last night. I wanted you gentlemen to know this."

Counsel for Goodson and Hannam thereupon moved for mistrial upon the ground of irregularity in the proceedings of the court, offering to prove that more was discussed in the telephone calls than the court had disclosed. The motion was summarily denied. Counsel for Goodson and Hannam thereupon called Smith as a witness and examined him. That examination established that in fact the trial court had discussed the merits of certain matters then under submission and indicated its intended ruling thereon. The trial court's feeble response was that the Court hadn't said that it was going to definitely rule as Smith had testified, but merely stated that that was its intention. (The court later did rule in accordance with Smith's account of the conversation.) Counsel for Goodson and Hannam then renewed the mistrial motion; the trial court again denied the motion, on the basis that it had already ruled that there was to be a constructive trust.

It is true that on May 26, 1970, the trial court had entered a minute order stating, "the court finds a constructive trust in favor of plaintiff Davis." However, under California law, that order was tentative and not binding on the court. Calif. Rules of Court, Rule 232 (a). Moreover, that order did not determine the extent or subject matter (whether stock or assets) of the constructive trust and that very matter had been extensively argued on June 2 and June 3, 1970. Indeed, one of the matters pending before the trial court on June 3, 1970 was the contention by counsel for Goodson and Hannam that any constructive trust should, at most, attach to less than all of the Custom stock owned by Goodson and Hannam. In the nocturnal telephone conversation with Smith the trial court stated that he was going to rule that the constructive trust applied to all of Goodson and Hannam's stock and that he had so informed Davis' counsel. Thus the telephone calls had related, in part, to a matter directly affecting Goodson and Hannam, as their counsel pointed out in his second motion for mistrial.

As the Court of Appeal recognized (*supra*, p. 12), the unfortunate telephone incident and the proceedings the next morning were not conducive to a calm and deliberate adjudication. The effect of the trial court's obvious misconduct and its exposure on the record by counsel for Goodson and Hannam was to create a bias on the trial court's part against Goodson and Hannam which denied them both the appearance and the substance of a fair trial from that time forward. The trial court thereafter demonstrated its inability to afford Goodson and Hannam a fair determination in the following obvious ways:

(1) Without affording defendants a hearing thereon, the trial court adopted the findings proposed by Davis' counsel, many of which were held to be defective in substantial respects by the Court of Appeal, (*supra*, p. 13.)

(2) The trial court held that the managerial salaries paid by Custom to Goodson and Hannam over more than 12 years were excessive and "surcharged" Goodson and Hannam for the asserted excess of almost $300,000. There was no testimony or other evidence either as to the reasonable value of their services or as to any standard therefor in the corporate executive field. The Court of Appeal summarily reversed this part of the judgment. (Appendix I, pp. 78, 80.)

(3) The trial court appointed Lewin, one of Davis' attorneys, as the independent custodian for Goodson and Hannam's 60.66% of Custom stock, together with the voting rights and powers pertaining thereto, an action which was reversed by Division Two of the Court of Appeal in preliminary appellate proceedings, as an abuse of discretion.

(4) The trial court ordered Custom's custodian to pay Custom's final bill for legal fees in the amount of $12,567 and later "surcharged" Good-

son and Hannam on account of the payment thus made pursuant to the court's own order.

(5) The trial court "surcharged" Goodson and Hannam for $103,000 of Custom investments in the Denes Company that had been authorized by court order prior to trial, after extensive evidentiary hearings.

(6) The trial court "surcharged" Goodson and Hannam for all legal fees paid by Custom to its own counsel on the ground that the legal services had actually been performed for Goodson and Hannam's benefit, even though on October 10, 1969 plaintiff's motion to prohibit Custom from paying or incurring any additional expense for its legal representation in this action had been denied by another judge.

Where the denial of a fair determination is so readily demonstrable, the probability of unfairness in other more subtle and undemonstrable ways is so great as to require that the entire matter be set at large for a new trial before an impartial court.

In *In Re Murchison*, 349 U.S. 133 (1955), this court uttered one of the classical definitions of due process of law and fair trial:

> "A fair trial in a fair tribunal is a basic requirement of due process. Fairness of course requires an absence of actual bias in the trial of cases. But our system of law has always endeavored to prevent even the probability of unfairness." (349 U.S. at 136.)

This Court has held that a judge must not give vent to personal feelings in rendering judgment and has reversed a judgment where this standard was not met, *Offutt v. United States,* 348 U.S. 11 (1954), in which the Court stated:

> "The vital point is that in sitting in judgment . . . the judge should not himself give vent to personal spleen or respond to a personal grievance. These are subtle matters, for they concern the ingredients of what constitutes justice. Therefore, justice must satisfy the appearance of justice." (348 U.S. at 14.)

A judgment must be reversed and the case remanded for a new trial where the trial court's attitude shows that the court was incapable of passing objective judgment on the evidence and the issues. *Whitaker v. McLean,* 118 F.2d 596 (D.C. 1941); *Moskum v. United States,* 143 F.2d 129 (6th Cir. 1944). The trial of the case must not only be fair in fact, but must also appear to be fair.

In *Whitaker v. McLean, supra,* a midtrial colloquy between the trial judge and counsel revealed the judge's bias and prejudice against plaintiff. The Court of Appeals reversed a judgment for defendants and remanded the case for a new trial, saying:

> "The judge may, as indeed he insisted, have felt no hostility to the plaintiff, and in that view he was, subjectively, free from bias. But bias must be considered objectively. Few, if any judges would make the reported remarks, in the course of a trial, unless they had developed definite and positive hostility to plaintiff and his case. Hostility is a form of bias . . . The policy . . . is that the courts of the United States 'Shall not only be impartial . . . but shall . . .' appear to be im-

> partial . . . a right to be tried by a judge who is reasonably free from bias is a part of the fundamental right to a fair trial. If, before a case is over, a judge's bias appears to have become overpowering, we think it disqualifies him." (118 F.2d at 596) (Emphasis added.)

b. Misapplication of State Rules of Appellate Procedure in Derogation of the Due Process Clause.

The Court of Appeal reversed portions of the judgment adverse to a principal minority stockholder of Custom on the ground of denial of due process, as against a contention of waiver advanced by Davis. The Court stated:

> "The trial court's conduct was a sufficiently fundamental departure from proper judicial standards to place it, when combined with the other errors, beyond the reach of this type of waiver." (Appendix I, p. 47.)

As heretofore noted, the Court of Appeal went so far as to reverse *sua sponte* another portion of the judgment adverse to Davis and favorable to the employee stockholder defendants, even though it recognized that Davis was not in a position to urge lack of due process as to him. On the other hand, the Court of Appeal salvaged sufficient of the tainted findings of the trial court to sustain in its view the judgment against Goodson and Hannam despite their detailed attack upon the sufficiency of the evidence to support those findings. In so doing, it relied upon California rules of appellate procedure holding a trial court's findings of fact unassailable if supported by evidence in the record, despite the fact that the appellate court later acknowledged the trial court's inability to proceed objectively to a calm and deliberate adjudication.

In this connection the Court of Appeal spoke of the trial court having "... applied its measure of credibility, drawn available inferences and made allocations of weight. . ." (Appendix I, p. 10) and later said:

> "The primary and fundamental attack of Goodson and Hannam against the breach of fiduciary duty and constructive trust aspect of the judgment is that Davis' trial court story most favorable to himself is unbelievable and can and should be rejected as such by this court even though the trial court believed it. The Davis version is unbelievable, they say, because it is inherently improbable that Goodson and Hannam would have spoken, acted and (inferentially) thought as Davis related and because Davis was caught in inconsistencies in his in-court and deposition testimony in the instant case and in a contradiction to both in a statement read into his Cook deposition. The factors of inherent improbability and of impeachment were for the trial court. [Citations omitted.] The appellate court cannot make its own evaluation of credibility, even though to some the evidence would have seemed so unbelievable as to compel a contrary judgment." (Appendix I, p. 20.)

The rule thus pronounced is ordinarily a salutary one, marking an appropriate demarcation between trial and appellate functions. But the rule obviously assumes that the trial court is unbiased and evenhanded—that the parties were afforded a fair hearing and dispassionate decision by the trial court. Where that is not the case, an appellate court which takes refuge in the rule abdicates its function—to guarantee *every* suitor, whatever his alleged wrongdoing, due process of law.

Denial of a fair hearing and, therefore, lack of due process is of paramount importance in this case. Goodson and Hannam are attorneys with previously unblemished records whose professional and personal lives are at stake. They deprived Davis of nothing—but instead made him the beneficiary of several millions of dollars of renegotiation and tax benefits to which he would be lawfully entitled only if the true version of the Custom Plan had been found by the trial court. As of now, they—not Davis—are the victims of fraud and chicanery. Lawyers, as well as criminals and minorities, are entitled to due process. On the record here, Goodson and Hannam have been denied a fair hearing and are entitled to reversal for lack of due process of law.

G. CONCLUSION.

Petitioners respectfully submit that certiorari should be granted for each and all of the foregoing reasons.

Respectfully submitted,

JOSEPH A. BALL,
Attorney for Petitioners.

BALL, HUNT, HART, BROWN &
BAERWITZ,
JOHN R. MCDONOUGH,

O'MELVENY & MYERS,
PHILIP F. WESTBROOK, JR.,
Of Counsel.

APPENDIX I.

Opinion of the California Court of Appeal.

Because this opinion is voluminous, this appendix is separately presented.

APPENDIX II.

Judgment.

Superior Court of the State of California, for the County of Los Angeles.

Allen V. C. Davis, et al., Plaintiffs, vs. Custom Component Switches, Inc., etc., et al., Defendants. No. 894 709.

Filed September 25, 1970.

The above-entitled cause came on regularly for trial before the undersigned, in Department 27 of the above-entitled Court, on January 29, 1970, and continued thereafter (with occasional periods of adjournment) until August 7, 1970. Plaintiffs appeared by Hillel Chodos and Kurt J. Lewin, Esq. Marvin Goodson and William E. Hannam, individually and as co-partners, and also as intervenors for limited purposes on behalf of Custom Component Switches, Inc., appeared by O'Melveny & Myers and Philip F. Westbrook, Jr., Esq.; and (as co-partners) also by Kirtland & Packard and Dickran Tevrizian, Esq. Thomas C. May, individually and as an intervenor for limited purposes on behalf of Custom Component Switches, Inc., appeared by Beardsley, Hufstedler & Kemble and Charles E. Beardsley, Esq. Glenn A. Berry, Don Griffith, Cal Casey, and Robert Miller, individually and as intervenors for limited purposes on behalf of Custom Component Switches, Inc. appeared by Monteleone & McCrory and Wilmer E. Windham, Esq.

Custom Component Switches, Inc. Appeared by Mitchell, Silberberg and Knupp and Howard S. Smith, Esq. until June 4, 1970, when the motion of said attorneys to be relieved from further representation of Custom Component Switches, Inc. was granted.

Ahmanson Bank appeared of record in this action by A. J. Weiss, Esq.; but prior to the reception of any evidence herein, the said A. J. Weiss appeared in open court, and, on behalf of Ahmanson Bank, waived the right to participate in the trial or to receive notice of interlocutory proceedings therein; and stipulated with all other parties to the action that the Ahmanson Bank was merely a stakeholder with respect to the shares of Custom pledged to it, and would be bound by the judgments and orders of this Court (if any) pertaining to the ownership and possession of said stock among the other parties to this action.

Evidence and argument, both oral and documentary, having been received and considered by the Court; and the Court having made its findings of fact and conclusions of law herein; the Court now renders judgment as follows:

1. It is hereby ordered, adjudged and decreed that all of the shares of Custom Component Switches, Inc. now standing of record in the names of Marvin Goodson and William E. Hannam (constituting 60⅔% of the shares of said corporation issued and outstanding) are impressed with a trust in favor of plaintiff Allen V. C. Davis; and Goodson and Hannam are hereby ordered to assign and deliver the ownership and possession of such shares to Davis forthwith, and to execute such documents and do such acts as may be necessary or appropriate to accomplish such assignment and delivery.

2. It is further ordered, adjudged and decreed that Custom Component Switches, Inc. is indebted to Davis on account of payments due him because of Custom's operations through June 30, 1970, in the sum of $3,495,095.08 as of August 31, 1970; and in addition, is indebted to Davis in the sum of $14,582.31, being in-

terest at the rate of 7% per annum on $3,041,467.32 from September 1, 1970, to the date of entry of this judgment.

3. It is further ordered, adjudged and decreed that Goodson and Hannam are jointly and severally indebted to Davis in the sum of $1,232,192.91, as compensatory damages.

4. It is further ordered, adjudged and decreed that Goodson and Hannam are each severally liable to Davis in the sum of $1.00, and that Davis is entitled to a several judgment against each of them for $1.00 for exemplary damages for fraud.

5. It is further ordered, adjudged and decreed that the agreements between Davis and Custom executed on December 10, 1957, are valid and subsisting; that the obligations of Custom to Davis thereunder are as set forth in those agreements (except to the extent that the provisions of this judgment may be different from or in conflict with said agreements, in which case this judgment shall be controlling); and that, with respect to all accounting periods of Custom commencing on or after July 1, 1970, payments to Davis shall be computed and made as follows:

(a) Sixty days after the end of each quarter, Custom shall pay Davis an amount equal to 70% of 65% of its net profits for said quarter (or 70% of 30% of its gross sales revenues for said quarter, if less).

(b) Ninety days after the end of each fiscal year, Custom shall pay Davis an amount equal to 65% of its net profits for that year (or 30% of its gross sales revenues for that year, if less), minus the total of the interim payments previosuly made to Davis on account of said fiscal year.

(c) In computing its gross sales revenues or net profits, Custom shall include all of its gross sales revenues or net profits (as the case may be) from all of its manufacturing and selling activities.

(d) Custom shall not engage in any manufacturing and selling activities unrelated to the inventions of Davis, or otherwise not subject to payment to Davis under the agreement, except with Davis' prior consent.

(e) In computing net profits, no deduction shall be made on account of Custom's franchise taxes accruing or paid during such period.

(f) Custom's obligation to make payments to Davis based on 100% of its gross sales revenues or net profits (as the case may be) shall not be affected by any decree limiting the scope of any patent covered by the agreement, or declaring invalid any patent or patents or any claim or claims of any such patents; but Custom's obligation to make payments to Davis based on 100% of its gross sales or net profits (as the case may be) shall continue so long as any claim of any patent or improvement patent covered by the agreement is in effect.

(g) In computing net profits, no deductions shall be made for expenses, except ordinary, necessary, and reasonable expenses incurred by Custom in operating its business.

(h) In the event of any default by Custom in the payment of its obligations, any patent rights or interests therein which may have previously been assigned to Custom by Davis, shall revert to Davis.

6. It is further ordered, adjudged and decreed that the shares of Custom standing of record in the names of Goodson and Hannam, and awarded to Davis by the provisions of Paragraph 1 hereof, shall belong to

Davis free and clear of any claims of Goodson, Hannam, May or Custom, except such claims as May and Custom may have by virtue of the stock purchase and sale agreement of January 15, 1965, and all amendments thereto made prior to September 30, 1966 (said agreement and amendments being attached to the third amended complaint on file herein as Exhibit 5); but that said shares shall belong to Davis free and clear of any restrictions or limitations arising by virtue of any agreements or amendments entered into among Goodson, Hannam, May or Custom with respect to such shares on or after September 30, 1966.

7. It is further ordered, adjudged and decreed that the shares of Custom standing of record in the name of Thomas C. May (constituting 30⅓% of the shares of Custom issued and outstanding) belong to May, free and clear of any claims of Davis or Custom; except that such shares are subject to the limitations and restrictions imposed upon them in favor of Custom and Davis by virtue of the stock purchase and sale agreement of January 15, 1965, and all amendments thereto made prior to September 30, 1966.

8. It is further ordered, adjudged and decreed that shares of Custom now standing of record in the names of Glen A. Berry, Don Griffith, Cal Casey and Robert Miller (constituting 5%, 2%, 1% and 1%, respectively, of the shares of Custom issued and outstanding) belong to them, free and clear of any claims of Davis; except that said shares are subject to such restrictions and limitations as are provided in the agreements of July 28, 1969, entered into between Custom and each of the said employee shareholders.

9. It is further ordered, adjudged and decreed that the funds heretofore deposited by Custom in the Court's

custody, pursuant to various interlocutory orders previously made herein, consisting of $1,400,000.00 principal plus interest accumulated on said deposits to the date of this judgment, shall be forthwith paid and delivered to Davis; and all amounts so paid to and received by Davis shall constitute a credit or offset for Custom against the amounts for which it is indebted to Davis pursuant to the provisions of Paragraph 2 of this judgment above set forth.

10. It is further ordered, adjudged and decreed that, if and when any payments are received by Custom in connection with the sale of its interest in the Denes Company to Potter-Englewood Company, Goodson and Hannam shall be entitled to receive an amount equal to 60⅔% of any such payment from Davis; and if, at the time Goodson and Hannam become entitled to any such payment from Davis, their other obligations to Davis under this judgment have not been fully satisfied and discharged, they shall be allowed a credit or offset against said other obligations, to the extent of the amounts due them under this paragraph.

11. It is further ordered, adjudged and decreed that Davis is entitled to a joint and several judgment against Goodson, Hannam and Custom for his costs in the sum of $ ....; that May shall recover his costs from plaintiff in the sum of $............................; and that Berry, Griffith, Casey and Miller, collectively, shall recover their costs in the aggregate sum of $.................... from plaintiff (the apportionment of costs among the said defendants being a matter with which plaintiff and this Court are not concerned).

Dated: September 25, 1970.

/s/ Steven S. Weisman
Judge of the Superior Court

APPENDIX III.

[illegible] of Appeal of the State of California

[illegible]

[illegible]

[illegible]

[illegible]

APPENDIX III.

In the Court of Appeal of the State of California, Second Appellate District, Division Five.

June 20, 1972, Division Five Minutes.

Davis v. Customcraft, [sic] etc. et al. Civil No. 37319.

The Court: Petitions (4) for rehearing denied.

CLAY ROBBINS, JR., Clerk of the Court of Appeal, Second Appellate District, State of California, do hereby certify that the preceding is a true and correct copy of an order of this Court, as shown by the records of my office.

Witness my hand and the seal of this Court this 13 day of October A.D., 1972.

CLAY ROBBINS, JR., Clerk
/s/ By Thomas J. Nolan
Deputy Clerk

Order Denying Hearing, After Judgment by the Court of Appeal, 2nd District, Division 5, Civil No. 37319.

In the Supreme Court of the State of California, in Bank.

Allen V. C. Davis v. Goodson et al. (and consolidated cases).

Filed: July 19, 1972. G. E. Bishel, Clerk.

Petitions of intervenors and appellants for hearing DENIED.

I, G. E. BISHEL, Clerk of the Supreme Court of the State of California, do hereby certify that the preceding is a true copy of an order of this Court, as shown by the records of my office.

Witness my hand and the seal of the Court this 19 day of July, 1972.

/s/ By JNR
Deputy Clerk
WRIGHT
Chief Justice

APPENDIX IV.

A. Pertinent Text of Sections of the Renegotiation Act of 1951.

50 U.S.C. Appx.

§ 1212. Contracts subject to renegotiation—Generally

(a) The provisions of this title [sections 1211-1224 of this Appendix] shall be applicable (1) to all contracts with the Departments specifically named in section 103(a) [section 1213a of this Appendix] and related subcontracts, to the extent of the amounts received or accrued by a contractor or subcontractor on or after the first day of January 1951, whether such contracts or subcontracts were made on, before, or after such first day, and (2) to all contracts with the Departments designated by the President under section 103(a) [section 1213(a) of this Appendix], and related subcontracts, to the extent of the amounts received or accrued by a contractor or subcontractor on or after the first day of the first month beginning after the date of such designation, whether such contracts or subcontracts were made on, before, or after such first day.

* * *

Excessive profits

§ 1213

(e) The term "excessive profits" means the portion of the profits derived from contracts with the Departments and subcontracts which is determined in accordance with this title [sections 1211-1233 of this Appendix] to be excessive. In determining excessive profits favorable recognition must be given to the efficiency of the contractor or subcontractor, with particular regard to attainment of quantity and quality production, reduction of costs, and economy in the use of materials, facilities, and manpower; and in addition, there shall be taken into consideration the following factors:

(1) Reasonableness of costs and profits, with particular regard to volume of production, normal earnings, and comparison of war and peacetime products;

(2) The net worth, with particular regard to the amount and source of public and private capital employed;

(3) Extent of risk assumed, including the risk incident to reasonable pricing policies;

(4) Nature and extent of contributions to the defense effort, including inventive and developmental contribution and cooperation with the Government and other contractors in supplying technical assistance;

(5) Character of business, including source and nature of materials, complexity of manufacturing technique, character and extent of subcontracting, and rate of turn-over;

(6) Such other factors the consideration of which the public interest and fair and equitable dealing may require, which factors shall be published in the regulations of the Board from time to time as adopted.

Subcontract

§ 1213

(g) The term "subcontract" means—

(1) any purchase order or agreement (including purchase orders or agreements antedating the related prime contract or higher tier subcontract) to perform

all or any part of the work, or to make or furnish any materials, required for the performance of any other contract or subcontract, but such term does not include any purchase order or agreement to furnish office supplies;

(2) any contract or arrangement covering the right to use any patented or secret method, formula, or device for the performance of a contract or subcontract; and

(3) any contract or arrangement (other than a contract or arrangement between two contracting parties, one of whom is found by the Board to be a bona fide executive officer, partner, or full-time employee of the other contracting party) under which—

> (A) any amount payable is contingent upon the procurement of a contract or contracts with a Department or of a subcontract or subcontracts; or
>
> (B) any amount payable is determined with reference to the amount of a contract or contracts with a Department or of a subcontract or subcontracts; or
>
> (C) . . . .

Person

(j) The term "person" shall include an individual, firm, corporation, association, partnership, and any organized group of persons whether or not incorporated.

Materials

(k) The term "materials" shall include raw materials, articles, commodities, parts, assemblies, products, machinery, equipment, supplies, components, technical data, processes, and other personal property.

§ 1215

Information available to board

(e) (1) Furnishing of financial statements, etc. Every person who holds contracts or subcontracts, to which the provisions of this title [sections 1211-1224 of this Appendix] are applicable, shall, in such form and detail as the Board may by regulations prescribe, file with the Board, on or before the first day of the fifth calendar month following the close of his fiscal year, a financial statement setting forth such information as the Board may by regulations prescribe as necessary to carry out this title [sections 1211-1224 of this Appendix]. The preceding sentence shall not apply to any such person with respect to a fiscal year if the aggregate of the amounts received or accrued under such contracts and subcontracts during such fiscal year by him, and all persons under control of or controlling or under common control with him, is not more than the applicable amount prescribed in subsection (f) (1) or (2) of this section; but any person to whom this sentence applies may, if he so elects, file with the Board for such fiscal year a financial statement setting forth such information as the Board may by regulations prescribe as necessary to carry out this title [sections 1211-1224 of this Appendix]. The Board may require any person who holds contracts or subcontracts to which the provisions of this title [sections 1211-1224 of this Appendix] are applicable (whether or not such person has filed a financial statement under this paragraph) to furnish any information, records, or data which are determined by the Board to be necessary to carry out this title [sections 1211-1224 of this Appendix] and which the Board specifically requests such person to furnish. Such information, records, or data may not be required with respect to any fiscal year after the date on which all liabilities of such person for excessive profits received or accrued during such fiscal year are discharged. Any person who willfully fails or refuses to furnish any statement, information, records, or data required of him under this subsection, or who knowingly furnishes any statement, information, records, or data pursuant to this subsection containing information which is false or misleading in any material respect, shall, upon conviction thereof, be punished by a fine of not more than $10,000 or imprisonment for not more than one year, or both.

* * *

§ 1215

Minimum amounts subject to renegotiation

(f) (1) Aggregate amounts received or accrued during fiscal year. If the aggregate of the amounts received or accrued during a fiscal year (and on or after the applicable effective date specified in section 102 (a) [section 1212(a) of this Appendix]) by a contractor or subcontractor, and all persons under control of or controlling or under common control with the contractor or subcontractor, under contracts with the Departments and subcontracts described in section 103 (g)(1) and (2) [section 1213(g)(1), (2) of this Appendix], is not more than . . . or $1,000,000, in the case of a fiscal year ending after June 30, 1956, the receipts or accruals from such contracts and subcontracts shall not, for such fiscal year, be renegotiated under this title [sections 1211-1224 of this Appendix]. If the aggregate of such amounts received or accrued during the fiscal year under such contracts and subcontracts is more than . . . $1,000,000, in the case of a fiscal year ending after June 30, 1956, no determination of excessive profits to be eliminated for such year with respect to such contracts and subcontracts shall be in an amount greater than the amount by which such aggregate exceeds . . . $1,000,000, in the case of a fiscal year ending after June 30, 1956.

B. Pertinent Text of Sections of the Renegotiation Board Regulations.

32 C.F.R.

§ 1452.6 Patent licenses—(a) *Statutory provision*—Section 103 (g) of the act provides in part as follows:

The term "subcontract" means—

(1) * * *

(2) any contract or arrangement covering the right to use any patented or secret method, formula, or device for the performance of a contract or subcontract; and * * *

(b) *Interpretation.*—Any contract or arrangement covering the right to use any patented or secret method, formula, or device for the performance of a renegotiable prime contract or subcontract is a subcontract within the meaning of section 103 (g) (2) of the act. It is not a subcontract within the meaning of section 103 (g) (3) of the act. (See § 1452.7.) In any case where a license and an agreement by the licensor to furnish any technical or other services to the licensee are embraced within a single contract, the agreement to furnish technical or other services may be a subcontract under section 103 (g) (3) of the act. In any such case, the license may be severed from the agreement to furnish technical or other services, and an appropriate finding made as to that portion of the consideration payable under the contract which is payable on account of the license and that portion of the consideration which is payable on account of the services.

§ 1458.6

§ 1458.6. Tests of "control".—For the purposes of section 105 (f) of the act, in determining whether the contractor controls or is controlled by or under common control with another person, the following principles will be followed:

(a) Corporate control: A parent corporation which owns more than 50 percent of the voting stock of another corporation controls such other corporation and also controls all corporations controlled by such other corporation.

(b) Individual control: An individual who owns more than 50 percent of the voting stock of a corporation controls the corporation and also controls all corporations controlled by the corporation.

(c) Partnership control: A general partner who is entitled to more than 50 percent of the profits of the partnership controls the partnership.

(d) Joint venture control: A joint venturer who is entitled to more than 50 percent of the profits of a joint venture controls the joint venture.

(e) Other cases: Actual control is a question of fact. Even though the foregoing conditions do not exist, the Board may determine that actual control exists.

§ 1499.1-5 Renegotiation Ruling No. 5: Subcontracts within the scope of the act: sales and other transfers of patents (interprets act section 103(g)(1) and (2), 103 (k); § 1452.6 of this chapter).

(a) Agreements between private persons for the sale or licensing of a patent are subject to the following rules:

(1) (i) Section 103(g)(2) of the act defines the term "subcontract" as including "any contract or arrangement covering the right to use any patented or secret method, formula, or device for the performance of a contract or subcontract; * * *." There is absent any reference to a transaction in which the owner by a present transfer divests himself of his title to the patented method, formula, or device. All that is dealt with is an arrangement under which the owner of the patent grants the contractor or subcontractor permission to use the method, formula, or device, retaining in himself the title thereto. In § 1452.6(b) and (c) of this chapter the Board interprets section 103(g)(2) of the act to include only licenses and other similar arrangements involving royalty payments.

(ii) Section 103(g)(1) includes in the definition of a subcontract "any purchase order or agreement * * * to * * * furnish any materials, required for the performance of any other contract or subcontract, * * *." While the term "materials," as defined in section 103(k) of the act, may be broad enough to include patents, the Board is of the opinion that, by dealing specially with patents in section 103(g)(2), Congress thereby limited the renegotiable scope of transactions involving patents to licenses for the use thereof. Plainly, Congress did not intend that sales of patents, providing for the present unconditional transfer of title from the owner to the purchaser, should be subject to renegotiation.

(2) A present unconditional transfer by the holder of a patent of all his right, title and interest therein for

its remaining life is one in which the transferee immediately acquires full rights of ownership, including the right to license others to use such patent, or to sell it and convey all his right, title and interests therein. The failure of a transfer to include either of these rights disqualifies the transaction as a present unconditional transfer. Accordingly, a transaction involving the retention of a security title to insure the vendor against loss upon a default in payment, or of a right of recapture upon default, would fall short of a present unconditional transfer of title to the patent, and would amount to no more than a "contract or arrangement covering the right to use" as described in section 103 (g)(2) of the act. The fact that the payment is to be made by the transferee on the installment basis, or on the basis of a percentage of sales or profits from the sale of articles or services covered by the patent, does not affect the question. See § 1452.6 of this chapter.

(3) A licensing arrangement which qualifies under the capital gain and loss provisions of section 1235 of the Internal Revenue Code of 1954 may nonetheless be subject to renegotiation. Section 1235 covers the treatment to be accorded for tax purposes to the transfer of "all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights." Section 1.1235-2(b)(2) of the regulations under the 1954 Code (26 CFR 1.1235-2(b)(2)) includes within the meaning of rights which are not substantial, retention by the transferor of (i) legal title for the purpose of securing performance or payment by the transferee; and (ii) rights in the property which are not inconsistent with the passage of ownership, such as retention of a security interest (vendor's lien), or a reservation in the nature of a condition subsequent

(provision for forfeiture on account of nonperformance).

(b) For renegotiation purposes, different rules prevail. The renegotiability of transactions involving patents is determined exclusively by the provisions of section 103(g)(2) of the Act. As indicated in paragraph (a)(2) of this section, retention of legal title or of a right of recapture causes the transaction to fall short of a present unconditional transfer of title, and such a transaction is subject to renegotiation. On the other hand, rentention of a vendor's lien is not inconsistent with an absolute sale and will not of itself subject the transaction to renegotiation. [Superseding former Renegotiation Rulings Nos. 94 and 95, 12/1-59.]

C. Pertinent Text of Sections of the Internal Revenue Code.

26 U.S.C. § 267

§ 267. Losses, expenses, and interest with respect to transactions between related taxpayers

(b) Relationships.—The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c) (4);

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations more than 50 percent in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation pre-

ceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

(4) A grantor and a fiduciary of any trust;

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary of a trust and a beneficiary of such trust;

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; or

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual.

(c) Constructive ownership of stock.—For purposes of determining, in applying subsection (b), the ownership of stock—

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

26 U.S.C. § 1235. Sale of exchange of patents

(a) General.—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent. or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) contingent on the productivity, use, or disposition of the property transferred.

(b) "Holder" defined.—For purposes of this section, the term "holder" means—

(1) any individual whose efforts created such property, or . . .

(c) Effective date.—This section shall be applicable with regard to any amounts received, or payments made, pursuant to a transfer described in subsection (a) in any taxable year to which this subtitle applies, regardless of the taxable year in which such transfer occurred.

(d) Related persons.—Subsection (a) shall not apply to any sale or exchange between an individual and any other related person (as defined in section 267(b)), except brothers and sisters, whether by the whole or half blood.

§ 7201. Attempt to evade or defeat tax

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

§ 7206. Fraud and false statements

Any person who—

(1) Declaration under penalties of perjury.—Willfully makes and subscribes any return, state-

> ment, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter; or
>
> . . .
>
> . . .
>
> . . .

shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $5,000, or imprisoned not more than 3 years, or both, together with the costs of prosecution.

§ 7207. Fraudulent returns, statements, or other documents

Any person who willfully delivers or discloses to the Secretary or his delegate any list, return, account, statement, or other document, known by him to be fraudulent or to be false as to any material matter, shall be fined not more than $1,000, or imprisoned not more than 1 year, or both.

D. Pertinent Text of Sections of the Treasury Regulations.

26 C.F.R. § 1.267

§ 1.267 (b)-1 *Relationships*—(a) *In general* (1) The persons referred to in section 267 (a) and § 1.267 (a)-1 are specified in section 267 (b).

§ 1.267(c) *Statutory provisions; losses, expenses, and interest with respect to transactions between related taxpayers; constructive ownership of stock.*

§ 1.267 (c)-1 *Constructive ownership of stock*—(a) *In general.* (1) The determination of stock ownership for purposes of section 267 (b) shall be in accordance with the rules in section 267 (c).

(2) For an individual to be considered under section 267 (c) (2) as constructively owning the stock of a corporation which is owned, directly or indirectly, by or for members of his family it is not necessary that he own stock in the corporation either directly or indirectly. On the other hand, for an individual to be considered under section 267 (c) (3) as owning the stock of a corporation owned either actually, or constructively under section 267 (c) (1), by or for his partner, such individual must himself actually own, or constructively own under section 267 (c) (1), stock of such corporation.

(3) An individual's constructive ownership, under section 267 (c) (2) or (3), of stock owned directly or indirectly by or for a member of his family, or by or for his partner, is not to be considered as actual ownership of such stock, and the individual's constructive ownership of the stock is not to be attributed to another member of his family or to another partner. However, an individual's constructive ownership, under section 267 (c) (1), of stock owned directly or indirectly by or for a corporation, partnership, estate, or trust shall be considered as actual ownership of the stock, and the individual's ownership may be attributed to a member of his family or to his partner.

(4) The family of an individual shall include only his brothers and sisters, spouse, ancestors, and lineal descendants. In determining whether any of these relationships exist, full effect shall be given to a legal adoption. The term "ancestors" includes parents and grandparents, and the term "lineal descendants" includes children and grandchildren.

§ 1.1235-1 *Sale or exchange of patents*—(a) *General rule.* Section 1235 provides that a transfer (other than by gift, inheritance, or devise) of all substantial rights to a patent, or of an undivided interest in all such rights to a patent, by a holder to a person other than a related person constitutes the sale or exchange of a capital asset held for more than six months, whether or not payments therefore are—

(1) Payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) Contingent on the productivity, use, or disposition of the property transferred.

(b) *Scope of section 1235.* If a transfer is not one described in paragraph (a) of this section, section 1235 shall be disregarded in determining whether or not such transfer is the sale or exchange of a capital asset. For example, a transfer by a person other than a holder or a transfer by a holder to a related person is not governed by section 1235. The tax consequences of such transfers shall be determined under other provisions of the internal revenue laws.

§. 1.1235-2 *Definition of terms.* For the purposes of section 1235 and § 1.1235-1—

(a) *Patent.* The term "patent" means a patent granted under the provisions of title 35 of the United States Code, or any foreign patent granting rights generally similar to those under a United States patent. It is not necessary that the patent or patent application for the invention be in existence if the requirements of section 1235 are otherwise met.

(b) *All substantial rights to a patent.* (1) The term "all substantial rights to a patent" means all rights which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction. A transfer limited in duration by the terms of the instrument to a period less than the remaining life of the patent is not a transfer of all substantial rights to a patent.

(2) Rights which are not considered substantial for purposes of section 1235 may be retained by the holder. Examples of such rights are:

(i) The retention by the transferor of legal title for the purpose of securing performance or payment by the transferee in a transaction involving transfer of an exclusive license to manufacture, use, and sell for the life of the patent;

(ii) The retention by the transferor of rights in the property which are not inconsistent with the passage of ownership, such as the retention of a security interest (such as a vendor's lien), or a reservation in the nature of a condition subsequent (such as a provision for forfeiture on account of nonperformance).

(3) Examples of rights which may or may not be substantial, depending upon the circumstances of the whole transaction in which rights to a patent are transferred, are:

(i) The retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee;

(ii) The failure to convey to the transferee the right to use or to sell the patent property.

(4) The retention of a right to terminate the transfer at will is the retention of a substantial right for the purposes of section 1235.

(c) *Undivided interest.* A person owns an "undivided interest" in all substantial rights to a patent when he owns the same fractional share of each and every substantial right to the patent. It does not include, for example, a right to the income from a patent, or a license limited geographically, or a license which covers some, but not all, of the valuable claims or uses covered by the patent. A transfer limited in duration by the terms of the instrument to a period less than the remaining life of the patent is not a transfer of an undivided interest in all substantial rights to a patent.

(d) *Holder.* (1) The term "holder" means any individual—

(i) Whose efforts created the patent property and who would qualify as the "original and first" inventor, or joint inventor, within the meaning of title 35 of the United States Code, . . .

(3) An individual may qualify as a holder whether or not he is in the business of making inventions or in the business of buying and selling patents.

(f) *Related person.* (1) The term "related person" means one whose relationship to another person at the time of the transfer is described in section 267 (b), except that the term does not include a brother or sister, whether of the whole or the half blood. Thus, if a holder transfers all his substantial rights to a patent to his brother or sister, or both, such transfer is not to a related person. However, if a holder transfers all his substantial rights to a patent to a corporation in which he owns more than 50 percent in value of the outstanding stock, he is considered as transferring such rights to a related person for the purpose of section 1235. On the other hand, if a holder transfers all his substantial rights to a patent to a corporation in which he owns 50 percent or less in value of the outstanding stock and his brothers owns the remaining stock, he is not considered as transferring such rights to a related person since the brother relationship is to be disregarded for purposes of section 1235.

(2) If a relationship described in section 267 (b) exists independently of family status, the brother-sister exception, described in subparagraph (1) of this paragraph, does not apply. Thus, if a holder transfers all his substantial rights to a patent to the fiduciary of a trust of which the holder is the grantor, the holder and the fiduciary are related persons for purposes of section 1235 (d). (See section 267 (b) (4).) The transfer, therefore, would not qualify under section 1235 (a). This result obtains whether or not the fiduciary is the brother or sister of the holder since the disqualifying relationship exists because of the grantor-fiduciary status and not because of family status.

APPENDIX V.

How the Federal Questions Sought to Be Reviewed Were Raised.

A. Questions Pertaining to Defense of Unenforceability of Plaintiff's Cause of Action Because of Its Illegality Under Federal Law and Policy.

(1) How the Federal Questions Were Raised In The Trial Court

a. The Seventh Affirmative Defense asserted in petitioner's Answer to the Third Amended Complaint, on which the case was tried, was as follows:

> SEVENTH AFFIRMATIVE DEFENSE
>
> 56. Goodson and Hannam repeat and incorporate herein by reference each and every allegation contained in paragraphs 5, 34 through 44, paragraphs 46 through 48, and paragraphs 50 through 52, and each of them.
>
> 57. By reason of the foregoing facts, plaintiff Davis is barred from asserting any claim for equitable relief by the doctrine of unclean hands. (Clerk's Transcript, Vol. A-II, pp. 322-323)

Paragraph 40 of said Answer, incorporated in Petitioners' Seventh Affirmative Defense by reference, alleged:

> 40. Since the execution of the agreements between plaintiff Davis and Custom and Custom Component Proportioners, Inc. and Custom Component Springs, Inc. in December, 1967, and to the date hereof, plaintiff Davis has received cash payments from said corpora'ions under said agreements in the total amount of $3,413,053.04. Goodson and Hannam are informed and believe and therefore allege that plaintiff Davis has re-

> ported all of such amount on his federal and state income tax returns as capital gains, and has excluded all of said amount from any computations and reports plaintiff Davis, any of the Hydra-Electric corporations, or plaintiff Hydra-Electric Company ever was or is now required to file under the provisions of the federal renegotiation acts. Goodson and Hannam are therefore informed and believe and therefore allege that plaintiff has taken full advantage of, and secured all the benefits he hoped to secure by the aforesaid agreements. (Clerk's Transcript, Vol. A-II, p. 317)

b. Upon the argument and submission of the liability issues to the trial court at the close of the evidence thereon, counsel for petitioners raised the issue of the illegality, under federal law and policy, of Davis' version of the Custom Plan as follows:

> MR. WESTBROOK: [Plaintiff's] testimony, if believed, would support a finding of actual fraud, would support a finding of a fraudulent scheme to evade taxes and to evade renegotiation, and that is a scheme to which a court of equity should not, and under the cases should not lend its assistance.
>
> Even in the case of transactions innocently entered into which have the effect of destroying the policy of the law, a court of equity will withhold its aid; much more where a transaction is described by Mr. Davis, would involve knowing tax evasion, knowing evasion of the renegotiation laws. Such an agreement would be illegal and unenforceable. (Reporters' Transcript, Vol. 22, p. 4542, line 26—4543, line 11)

* * *

> The key to the Custom plan was to be and continued to be a corporation completely separate and independent of Mr. Davis. That was the only way that Mr. Davis could get the benefits he has received in terms of avoidance of renegotiation and the realization of income on a capital gain basis in an amount approximating $3,500,000 through April 30, 1966. . . .
>
> If Davis had in fact had the ownership of Custom that whole plan would have been a fraud. It would have been a fraud on the tax law. It would have been a fraud on the renegotiation law. If Mr. Davis were to be believed, it would be an intentional fraud. (Reporter's Transcript, Vol. 22, p. 4643, line 25—4644, line 16)

c. In the argument of the liability issues, counsel for defendant Custom Componant Switches, Inc.* raised the issue of the illegality, under federal law and policy, of Davis' version of the Custom Plan as follows:

> MR. SMITH: . . . Allen Davis in his deposition and on the witness stand in this court has testified that he was a knowing, willing participant in an express agreement to defraud the United States of America both in taxes and in renegotiation. . . .
>
> . . . . He is saying, "Judge Weisman, I want you to enforce this secret agreement to defraud the government, this agreement which I say I have

---

*Davis had prayed that a constructive trust be imposed on all of Custom's assets. Therefore, Custom pleaded essentially the same defenses as Goodson and Hannam. With approval of the trial court, counsel for Goodson and Hannam and counsel for Custom divided the argument so that contentions raised by either with respect to liability was on behalf of Goodson, Hannam and Custom.

> . . . ." (Reporter's Transcript, Vol. 22, p. 4652, lines 9-22)
>
> * * *
>
> Mr. Davis has come in and has testified that he had a secret agreement to make misrepresentations, to file false tax returns, not to treat receipts subject to renegotiation because he had a secret agreement that the premises on which he obtained those tax and renegotiation benefits were false. The premises were that there was no relationship between him and Custom and that he had made a sale of a patent. And he came in and testified, "I really didn't make a sale. I have an agreement. I could get it back any time I wanted it."
>
> Now I point out to your Honor there has been a lot of technical discussion of Section 1235 of the Revenue Code. But not even 1235 would countenance that kind of transaction.
>
> Mr. Davis has come in, he has testified to this fraudulent scheme, and he is asking your Honor to enforce it. . . . (Reporter's Transcript, Vol. 22, p. 4666, line 13—4667, line 15)

The trial court nevertheless ruled in favor of plaintiff Davis on the liability issue, entering a judgment on September 25, 1970, favorable to plaintiff which, in effect, specifically enforced Davis' version of the Custom Plan. (Clerk's Transcript, Vol. IV, p. 867)

(2) How the Federal Questions Were Raised in the California Appellate Courts

a. In petitioner's Opening Brief in the Court of Appeal they sought reversal of the judgment on the ground, *inter alia,* that "Davis' Cause of Action is Unenforceable as a Matter of Federal Law and Policy as Well as of State Law and Policy," citing *Anderson v. Carkins,* 135 U.S. 483 (1890) and other pertinent federal cases (Opening Brief, pp. 115-117). The point was reasserted in petitioner's Reply Brief, pp. 3-4, 9.

The Court of Appeal affirmed the judgment against petitioners, with minor qualifications, in an opinion filed on May 23, 1972.

b. In their Petition for Rehearing in the Court of Appeal petitioners asserted, as a ground for rehearing, "This Court Failed to Decide the Substantial Issue Whether the Custom Plan, as Testified to by Davis and Found by the Trial Court, is Illegal and Unenforceable as a Matter of Federal Law" (Petition for rehearing, pp. 14-15).

The Court of Appeal denied petitioners' Petition for Rehearing on June 20, 1972.

c. In their Petition for Hearing in the California Supreme Court petitioners asserted, as a ground for hearing, that "Under Anderson v. Carkins and Other Federal Cases, One Who Purposefully Engages in a Course of Illegal Conduct Designed to Defraud the Federal Government is Precluded, by Overriding Federal Law, from Enforcing in Any State or Federal Court a Cause of Action Arising out of Such Conduct" (Petition for Hearing, 49-52).

The California Supreme Court denied petitioners' Petition for Hearing on July 19, 1972.

B. Questions Pertaining to the Trial Court's Misconduct, Bias and Prejudice Which Denied Defendants a Fair Determination.

(1) How The Federal Questions Were Raised In The Trial Court

a. On June 4, 1970, following the trial court's disclosure of its telephone calls to counsel for plaintiff and for defendant Custom Component Switches, Inc. on the evening before, petitioner's counsel moved for a mistrial, which was denied:

> MR. WESTBROOK: At this time, your Honor, I wish to move for a mistrial in this case upon the ground of irregularity in the proceedings of the Court. Your Honor may feel that it was not important to have all counsel present in the conversation last evening, but I'm informed, and I'm prepared to prove, that more was discussed than your Honor has indicated from the bench this morning. That there were comments with respect to the merits of the case and that there were comments by your Honor with respect to your intended ruling with regard to certain aspects of the case. As far as my clients are concerned, there are very important matters still pending before your Honor and I submit that it was improper and highly irregular to communicate with counsel about the case while the matter is still pending. On that ground I make my motion.
>
> THE COURT: The motion is denied. (Reporter's Transcript, Vol. 24, p. 5089, lines 7-25)

b. After Attorney Howard Smith, counsel for Custom Component Switches, Inc., testified to what the trial court had said in their telephone conversations the evening before, petitioners' counsel renewed his motion for mistrial and this motion was also denied:

> THE COURT: . . . does anyone else have anything further. . . . Mr. Westbrook?
>
> MR. WESTBROOK: Other than to simply renew my motion at this time, your Honor. . . .
>
> MR. SMITH: Your Honor, in my capacity as counsel for defendant Custom I would join in that motion. . . .
>
> THE COURT: Well, I am going to deny all these motions for a mistrial. . . .
>
> * * *
>
> THE COURT: . . . All right, Mr. Westbrook. What do you wish to tell me?
>
> MR. WESTBROOK: I simply wish to point out for the record, your Honor, that there is under submission to your Honor, or pending before your Honor, the issue as to how much stock the trust should be imposed upon. Your Honor apparently has forgotten my argument that it should be less than 49 percent.
>
> THE COURT: I have not forgotten, Mr. Westbrook.
>
> MR. WESTBROOK: Thank you, your Honor. That matter is pending before your Honor as well as other matters affecting my clients' rights vitally.
>
> THE COURT: Do you wish to make any other statement?
>
> MR. WESTBROOK: No, your Honor.
>
> THE COURT: All right. Well, again, the motions for mistrial, in which Mr. Windham has joined, are denied. (Reporter's Transcript, Vol. 24, p. 5119, line 21 to 5127, line 9)

(2) How The Federal Questions Were Raised In The California Appellate Courts

a. In its opinion the Court of Appeal said that ". . . the trial judge's judicial mood was affected by the telephone incident and its aftermath and the justifiable shock displayed by counsel. . . . It may not have been in the judicial frame of mind to afford the parties a fair determination. The unfortunate incident and its aftermath were not conducive to a calm and deliberate adjudication. Determination of an issue without a fair hearing may constitute a denial of due process and reversal error *per se*." (Appendix I, p. 44). On the basis of this pronouncement, the Court of Appeal reversed the judgment as to defendant Thomas C. May and in part as to plaintiff, although plaintiff had not sought reversal on that ground.

b. In their Petition for Rehearing in the Court of Appeal, petitioners asserted, as a ground for rehearing: "The Judgment Should be Reversed as to all Defendants Because of the Trial Judge's Misconduct and its Prejudicial Reaction to the Events of June 4, 1970" (Petition for Rehearing, pp. 16-23).

c. The Court of Appeal denied the Petition for Rehearing on June 20, 1970.

In their Petition for Hearing in the California Supreme Court, petitioners asserted, as a ground for hearing: (1) "The Trial Court's Judicial Misconduct and its aftermath Prejudiced the Whole Trial; Therefore, the Judgment Must be Reversed and a New Trial

Granted as to all Parties on All Issues and (2) "The Trial Court's Traditional Power To Determine Issues Of Fact Should Not Be Sustained, In A Case In Which A Primary Ground Of Appeal Is That The Findings Are Not Supported By The Evidence, Where The Trial Court Lost Its Capacity To Conduct A Fair Trial." (Petition for Hearing, pp. 24-35).

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Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1972

No. 72-611

Marvin Goodson and **William E. Hannam,**

Petitioners,

vs.

Allen V. C. Davis, Custom Component Switches, Inc., Thomas C. May, Glen A. Berry, Don Griffith, Cal Casey and **Robert Miller,**

Respondents.

VOLUME II.

APPENDIX I.

Opinion of the California Court of Appeal.

JOSEPH A. BALL,
450 North Roxbury Drive,
Beverly Hills, Calif. 90210,
(213) 278-1960,
Attorney for Petitioners.

BALL, HUNT, HART, BROWN & BAERWITZ,
JOHN R. McDONOUGH,
450 North Roxbury Drive,
Beverly Hills, Calif. 90210,
(213) 278-1960,

O'MELVENY & MYERS,
PHILIP F. WESTBROOK, JR.,
611 West 6th Street,
Los Angeles, Calif. 90017,
(213) 620-1120,
Of Counsel.

Parker & Son, Inc., Law Printers, Los Angeles. Phone 724-6622

APPENDIX 1.

Opinion of the Court of Appeal.

In the Court of Appeal of the State of California, Second Appellate District, Division Five.

Allen V. C. Davis, Plaintiff and Respondent, vs. Marvin Goodson and William E. Hannam, individually and as co-partners, dba Goodson & Hannam, Defendants and Appellants.

Allen V. C. Davis, Plaintiff and Respondent, vs. Thomas C. May, Glen A. Berry, Don Griffith, Cal Casey, Robert Miller, Marvin Goodson and William E. Hannam as Interveners on behalf of defendant Custom Component Switches, Inc., Interveners and Appellants.

Allen V. C. Davis, Plaintiff and Respondent, vs. Thomas C. May, Defendant and Appellant.

Allen V. C. Davis, Plaintiff and Respondent, vs. Cal Casey and Robert Miller, Defendants and Appellants.

Allen V. C. Davis, Plaintiff and Appellant, vs. Marvin Goodson and William E. Hannam, Thomas C. May, Glen A. Berry, Don Griffith, Cal Casey, Robert Miller, Marvin Goodson and William E. Hannam and Interveners on behalf of defendant Custom Component Switches, Inc., Defendants, Interveners, and Respondents.

Allen V. C. Davis, Plaintiff and Respondent, vs. Thomas C. May, Defendant and Appellant.

Goodson, Hannam, May and Custom Component Switches, Inc., a corporation, Defendants and Respondents. 2d Civ. No. 37319, Sup. Crt. No. 894,709.

Filed May 23, 1972.

APPEALS from a judgment of the Superior Court of Los Angeles County and from orders. Steven S. Weisman, Judge. Judgment affirmed in part and reversed in part with directions. Appeals from order precluding payment of legal expenses dismissed. Order requiring withdrawal of petition for arrangement affirmed.

Hillel Chodos and Kurt Lewin for Allen V. Davis, Plaintiff, Respondent and Appellant.

Beardsley, Hufstedler & Kemble, Charles E. Beardsley, Seth M. Hufstedler and Jerome H. Craig for Thomas C. May as Intervener on behalf of Custom Component Switches, Inc., and as Appellant.

Monteleone & McCrory, and Wilmer E. Windham, for Glen A. Berry, Don Griffith, Cal Casey and Robert Miller, as Interveners on behalf of Custom Component Switches, Inc.

O'Melveny & Myers, Philip F. Westbrook and B. Boyd Hight, for Marvin Goodson and William E. Hannam, as Interveners on behalf of Custom Component Switches, Inc., and for Marvin Goodson and William E. Hannam, Appellants.

Ball, Hunt, Hart, Brown & Baerwitz, and Joseph A. Ball and John R. McDonough, for Marvin Goodson and William E. Hannam, as Appellants.

Since we are not certifying our opinion for publication, we do not set forth initially a recital of the facts or of the procedural steps in the litigation with which aspects of the case the parties and their counsel, of course, are fully familiar.

NOMENCLATURE

It is expedient to adopt a form of abbreviated nomenclature for individuals, entities, and features involved in the case. Our version follows:

1. *Names:* For brevity's sake we use just last names of the principals, witnesses and attorneys.

2. *Goodson and Hannam:* We use the two names without discrimination as to whether the actor or speaker involved in any given aspect of the case is Goodson or Hannam, since both are bound by the acts or words of the other.

3. *Employee shareholders:* Berry, Griffith, Casey and Miller, as minority shareholders of Custom when referred to separately from May.

4. *Minority shareholders:* May and employee shareholders when referred to as the total group of minority shareholders.

5. *Defendants:* Goodson and Hannam, Custom, and the minority shareholders when a reference to all of them is appropriate.

6. *Interveners:* The minority shareholders and Goodson and Hannam on behalf of Custom, as allowed by the trial court.

7. *Hydra:* The business owned and operated by Davis in any of the various forms which it took at times relevant to the action.

8. *Custom:* The corporations, collectively or separately, formed to take the assignment of an undivided one-half interest in Davis' patents, as said corporations existed from time to time until ultimately being resolved into Custom Component Switches, Inc. Davis has argued that at all times when there was mul-

tiple existence, the three entites should be considered as one under an integrated plan. We consider this a sound approach.

9. *The I.R.S.:* The Internal Revenue Service of the United States.

10. *The R. Bd.:* The Renegotiation Board of the United States.

11. *Attorney and Client:* This terminology includes the concept also of certified public accountant and client when the reference is to Goodson and Hannam and Davis, since Goodson and Hannam bore both relationships to Davis. The professional in each relationship, of course, sustains toward the client a very high duty of integrity and fidelity.

12. *Royalty:* A word of convenience, as employed by counsel, to cover the purchase price for the undivided one-half patent interests assigned by Davis to Custom.

13. *Means for reverter:* (Explained later in the opinion.)

14. *The Custom Plan:* The plan encompassing Custom's formation, its purchase of an undivided one-half interest in Davis' patents, and its operation and its payment of royalties to Davis, all to the end of avoiding renegotiation disadvantageous for Davis and of effectuating his receipt of capital gain income.

15. *60 percent block:* Used to refer to the 60.67 percent of Custom stock which was in the name of Goodson and Hannam and upon which the constructive trust was imposed; the "res" of that trust.

16. *Stock rights:* Used as an abbreviation for the combination of Custom's and the 60 percent block's

rights of purchase of the stock of the employee shareholders, May's right of purchase of the stock of Goodson and Hannam, and May's indemnity-security right in the stock of Goodson and Hannam.

17. *Surcharge:* Term chosen as a word of convenience[1] by the trial participants, which we adopt, to describe generally the type of disgorgement (damages) sought to be drawn from Goodson and Hannam as constructive trustees and as attorneys who had breached their professional and fiduciary duty to their client.

HYDRA'S PROCEDURAL STATUS

Initially we note that although Hydra was a party plaintiff no judgment was rendered in its favor. This was due to the proposal of Chodos, made after the trial court had determined that the constructive trust would be imposed only on the Custom stock of Goodson and Hannam, that it be imposed only in favor of Davis personally. Hydra should have dismissed its suit or the judgment should have provided that it take nothing. The absence of reference to Hydra can be construed as the latter.

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[1] Obviously not used in its strict equity sense—"To show that a particular item, in favor of the party surcharging, ought to have been included, but was not, in an account which is alleged to be . . . complete." (Black's Law. Dict. (4th ed. 1951) p. 1610.) It could also be called "ancillary" relief. (Compare *SEC v. Manor Nursing Centers,* U.S. Ct. of App. (2d Cir.) January 21, 1972 (September term '71—Dkt. Nos. 71-2011, 2012, and 2026.) (Judgment required the "disgorging" of all proceedings (profits) received in connection with the public offering of Manor stock. A trustee was to receive the funds and distribute to defrauded investors. Said the court: "Clearly the provision requiring the disgorging . . . was a proper exercise of the District Court's equity powers." (P. 1496.)

APPELLATE GUIDES

We have kept in mind the function of an appellate court to review errors of law, to consider the weight of evidence only in evaluating error, and not to pass on questions of fact; what constitutes substantial evidence; the rules of conflicting evidence and inferences; and the presumption in favor of a judgment, especially as to presuming the trial court's reliance on findings found to be clear and sufficient and disregarding inadequacies of other findings.[2] These principles are ably

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[2] Where a finding is lacking in evidential support but is on a matter which is of so little materiality that a finding either way would not influence the judgment, other findings being sufficient to support the judgment, the error is harmless. (6 Witkin, Calif. Proc., Appeal, § 307, p. 4288.)

Some of the findings are not fully supported or are extravagantly put. The parts that are in this category are not necessary to support the judgment. We allude to most of them in the material following to demonstrate this point of view.

The suggestion in Findings 12 and part of 13 that the Custom Plan was an extension of the Hydra arrangement appears to have been desired by Davis to avoid a contention that the Custom Plan was new legal business, putting the fee aspect within the exception clause of Civil Code section 2235. It was stretching things but it was not necessary. However, it was inferable that the preexisting relationship led to a mutual understanding that Goodson and Hannam were the attorneys Davis would look to in the tax and governmental regulation field.

The wording in Finding 12 that the best course for Davis to pursue was to transfer the largest portion possible of his business to Custom seems to be an extravagant way of covering the start-up help and diversion of orders.

A portion of Finding 13(a) speaks of a representation that it was *necessary* for Davis to establish a "second source" to forestall a bypassing of his patents and to improve his renegotiation position. The word "desirable" and a reference to *possible* bypassing would have made the finding more accurate.

A portion of Findings 13(c) and 27(a) states, in effect, that Goodson and Hannam represented that the Custom Plan had been devised to retain, among other things, maximum ownership interest in the transferred business. This appears to have been an inadvertent inclusion.

(This footnote is continued on next page)

set out in 6 Witkin California Procedure (2d ed.) Appeal, sections 209 and 322, pages 4200 and 4300; sections 248 and 249, pages 4240 and 4241; sections 245 and 254, pages 4236 and 4245-4246; and section 235, pages 4225-4226. We feel that the pronouncements of Division Two (*Davis v. Custom Component*

Part of Finding 26(a) says that the royalty percentages were represented as the maximum possible under the rules. There is no such specific testimony. A more acceptable inference would be that they were in Goodson and Hannam's opinion the maximum defensible to avoid a government position of common control or ordinary income.

Finding 14(c) is to the effect that Davis could have had a substantial stock interest in Custom without incurring government disfavor. If this were put in the vein of a good possibility and not of a certainty, it would be appropriate.

Findings 14(e) and 31 in part say that Davis could have advanced start-up capital without jeopardizing the Custom Plan and that May being a shareholder was of no benefit. Again these points would have been stated better as good possibilities rather than certainties.

Finding 14(f) is to the effect that there was no substantial reason for the "handshake" period. There was the reason of the short time for diversion of Hydra profits. However, the lack of integrity of this finding is in no way fatal to Davis.

Part of Finding 26(b) is that Goodson and Hannam represented that "in any instance where the provisions of the patent assignment agreements might be different from . . . or silent with respect to, the terms of their original oral understanding, the oral understanding would control . . . ." There appears to be no evidential support for this. Also, it might run afoul of the parol evidence rule. (*Masterson v. Sine*, 68 Cal.2d 222, 227; Rest. of Contracts, § 240(1) (b).) Perhaps this rule would not apply where a fiduciary has a duty to point out nonconformities. Anyway the concept of the finding did not really come into play.

Finding 28 makes the point that the payment to Hydra by Custom for start-up items was low. We find little support. There is no money award because of this. Perhaps it was intended as showing a Goodson and Hannam violation of duty. It was not needed.

Finding 33 is to the effect that all of Custom's profits result from the business transferred by Davis and would have been made by Davis. This is all right if intended to mean simply that there is no telling how Custom would have fared if Davis had only assigned the patent interests and provided no start-up help, technical aid or diversion of orders.

Switches, Inc., 13 Cal.App.3d 21) are not conclusive because it did not have the advantage of the full record in this matter when required to rule.

CONSTRUCTIVE TRUST

There is no question but that Davis' version of the interaction between him and Goodson and Hannam, if it is not subject to being found inherently improbable or incredible or if, for complicity in fraud vis-a-vis the government, it does not put him beyond the assistance of the court, qualified him for the constructive trust remedy which was afforded him. The essence of that version is that Goodson and Hannam took advantage of the renegotiation adversity which beset Davis, of their position as his existing, trusted and highly rated attorneys called in to find a remedy for the threatened harm, of their special and intimate knowledge of the situation, and of the trust and confidence which Davis imposed in them, to get him, by making to him false representations[3] and withholding essential advice, to adopt a remedial plan which they could and did manipulate to foster their own interests at his expense.[4]

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[3] In other words, when Goodson and Hannam were mentally developing the Custom Plan they saw how a takeover of a substantial part of Hydra's market potential could be accomplished and took advantage of their client's need to avoid renegotiation with the end in mind of feathering their own nest.

[4] One series of representations by Goodson and Hannam to Davis was made when the Custom Plan was first proposed; another series, some simply replications, was made when the written assignments were executed. Since we do not feel that any demarcation between the two events is significant to the disposition of the constructive trust issue and since all such representations were made, according to the finding of the trial court, to induce Davis to enter into the Custom Plan and proceed with it, both in its contingent and committed stages, it is convenient to lump them together in our consideration. The first series substantially committed Davis to the Plan. Since, at the time of the execution of the documents, the complications of withdrawing from the

The Civil Code section 2235 presumption, which at one point might have been applicable, is an Evidence Code presumption under sections 601(a) and 605 which imposed upon Goodson and Hannam the burden of proof of the nonexistence of undue influence and insufficiency of consideration. (*Rebmann v. Major*, 5 Cal.App.3d 684, 688.) It did not enter into the ultimate determination of the trial court. Therefore, the presentation of an analysis thereof is not indicated, although we made one. On June 3 the trial court, when giving its reasons for having determined in March that there would be a constructive trust of some kind, stated that it did not believe that the situation was excepted from Civil Code section 2235 under the amendment and further that it had not thought that the presumption had been overcome. It then announced, after the scope of the trust had been argued, that "when I rule I rule sincerely" and that "I sincerely believe that these two defendants [Goodson and Hannam] are liable for fraud";[5] and it provided for nominal punitive damages to make clear its conviction that Goodson and Hannam had practiced actual fraud. Clearly it then was doing more than saying that the evidence negativing undue influence and insufficiency of consideration had not preponderated over that indicating it. The trial court was looking beyond those areas and was finding Goodson and Hannam guilty of actual fraud and deceit. something more than exercising mere undue influence and giving inadequate consideration. As to that greater

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Plan, if Davis had had second thoughts, were not so severe as they would become, the second series of representations can be said to have had some point to Goodson and Hannam, that is, to make sure that Davis strung along with the Plan.

[5] Also, Smith testified, without later contradiction by it that the trial court had told him that it "was convinced that Goodson and Hannam had taken Davis."

wrong, the burden of proof was on Davis, and the trial court decided he had met it.

In the last analysis, when the constructive trust phase of the suit was completed and the trial court had applied its measure of credibility, drawn available inferences, and made allocations of weight, the main factors[6] upon which Davis' case against Goodson and Hannam rested (which we feel the findings adequately cover either by their specific language or by implications inherently within or logically ancillary to them (*Surety Sav. & Loan Ass'n. v. National Automobile & Cas. Ins. Co.*, 8 Cal.App.3d 752, 760; *Kerr Land & Timber Co.* v. *Emmerson*, 268 Cal.App.2d 628, 635; 4 Witkin, California Proc., Trial, § 339, pp. 3140-3141), and not made unavailable by specific objection (Code Civ. Proc., § 634) are these:

(1) Goodson and Hannam told Davis, in effect, that they would take salaries from Custom; that in light

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[6] We limit ourselves to essentials to avoid entanglement in an endless intricacy of details.

There were other factors indicating that Goodson and Hannam had diverged from their duty of professional loyalty to Davis and had been remiss in giving Davis full and proper advice. By way of example we give brief identification to a few. Goodson and Hannam put themselves in a position of conflicting interests and obligations: to Davis, to Custom, and to May. (Note that Goodson and Hannam were under an $18,000 retainer to May up to 1958 and then $6,000 to 1965.) Goodson and Hannam did not explain this to Davis. Also, they failed to advise that their stock ownership could be a reportable possibility of common control; that once the R. Bd. was satisfied there was a genuine sale of patent interest to an entity not under common control, the royalty percentage was no problem; that renegotiation "pluses" of instant secondary source and provision of technical data and know-how gave leeway for some stock interest and security right. Goodson and Hannam did not make all facets of the Custom Plan fully known to the minority shareholders, so as to prevent bona fide purchaser status from insulating them from vendor's lien or constructive trust claims by Davis.

of this they would not charge him an attorney's fee for conceiving of and implementing the Custom Plan and for rendering future legal services; that their ownership of the majority of Custom stock was to enable them to manage Custom so as to best promote the objects of the Custom Plan.

This was repudiated in due course or may even have been put out at the time as a ruse to influence Davis. Goodson and Hannam told the trial court, falsely according to its evaluation, that it had been mutually agreed that their attorneys' fees would be 51 percent of the stock of Custom.[7] It is to be noted that Goodson and Hannam paid $2500 to Custom for their stock and that the witness, Hochman, testified that the taking of an ownership interest in the "res", although done occasionally, was not customary.

(2) Goodson and Hannam told Davis that it was imperative that he not own any stock in Custom, and its stock structure was formed accordingly. This kept Davis from having even a porthole from which he could

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[7] Compare *Estate of Kromrey,* 98 Cal.App.2d 639, where the attorney induced his client to promote his appointment as administrator of certain family estates, used his status to take possession of certain property as if doing so in that capacity, and then, when client shortly died, fraudulently claimed that the property had been given to him personally. Besides indicating that the Civil Code section 2235 presumption could have been used as evidence (which would not be the case now) the reviewing court said:

> "Indeed, it is difficult to understand how counsel for appellant can seriously contend before this court that the record does not support such conclusion of the trial court. The record in the instant case not only justifies but almost compels the conclusion that appellant not only violated the confidential relationship between attorney and client but also violated the ethics of the legal profession. All the perfumes of Araby could not impart a pleasing odor to such a transaction." (P. 646.)

have noted some of Goodson and Hannam's moves to turn the Custom Plan to their own advantage and aggrandizement.

Davis, of course, could have had up to 50 percent of the stock without getting into common control as a matter of law. No doubt ownership of that much would have been unwise, but the tenor of the expert testimony suggests that a small ownership for surveillance purposes would not have been indefensible. In any event, Davis was not made knowledgeable and given the opportunity to make a considered choice. As Davis put it, "[Goodson and Hannam] said that 'This is what you ought to do,'" and they said that "that would be the best thing [he] could do."

(3) Goodson and Hannam told Davis that the stock to be issued to May and any employee shareholder (Humphrey at that time) would be subject to an agreement for repurchase at book value (a type of redemption) by Custom, and they gave Davis the impression that this was to make more feasible their working out a means for reverter.

Goodson and Hannam did not arrange this as to the stock of May or Humphrey. When Humphrey died, Davis was able to persuade the widow to sell the stock back to Custom. The stock which later issued to the employee shareholders was made subject to such an agreement, but Goodson and Hannam, during pendency of the suit, spearheaded the elimination of that right upon termination of employment. May's stock was never made subject to a redemption provision.

(4) Goodson and Hannam represented to Davis, in effect and in general, that as his attorneys they would set up the agreement between him and Custom and

would conduct their independent powers of management in a manner to achieve as much benefit for him as possible.

However, they drafted the patent assignment contract so that: (1) its only reasonable construction was that Custom was at liberty to process products not encompassed in or related to the patents free of royalty obligation, and (2) one construction was that a royalty obligation endured only so long as all patents were extant or that royalty obligation attached to each patent and endured only so long as that patent existed. This would contrast with the obligation to pay the full royalty on the processing of all items, whether the patents to which they related remained extant or not, as long as a claim of any patent or improvement patent existed.

Further they caused Custom to deduct California corporate franchise taxes before computing royalties. They proposed a tapering down of royalties. When Davis retained attorney Keatinge and filed suit, that circumstance did not suddenly sanitize Goodson and Hannam's pre-existent wrongful purpose nor render less reprehensible the flaunting of solemn obligations and high standards deriving from the preexisting relationship of attorney and client.[8] However, Goodson and Hannam caused Custom to forego conservation of its assets, disburse substantial dividends, pay excessive salaries to themselves,[9] pay consulting fees to May for unrendered

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[8] Goodson and Hannam had the attitude that after Davis filed suit they were at liberty to disregard their professional commitments. Goodson and Hannam revealed this outlook when they testified that "the agreement had been in full force . . . at least until the balloon went up in the air in 1966."

[9] Note that the result of the payment of dividends and of excessive salaries was to put Custom assets where questionable fi-

(This footnote is continued on next page)

services, expend large sums in purchasing stock of and making loans to Denes Co., pay very substantial attorneys' fees and litigation expenses to counsel for itself and for themselves and May. In addition, Goodson and Hannam caused Custom to claim that it had been and was processing products not related to the patents upon which it should not have paid and did not have to pay royalties, and to claim that the switch patent was invalid and it therefore had not been and was not required to pay royalty on the processing of items related to that patent.

(5) Goodson and Hannam assured Davis that they would remain his professional advisors and foreseers in tax and renegotiation matters, particularly from the standpoint of the continued efficacy of the Custom Plan.

Their intention was not to do so, but to leave the impression with Davis that they were doing so. They made the claim to the trial court that they told Davis that as the controllers of Custom they could not remain as his advisors and urged him to secure other and independent counsel. The trial court may, and was entitled to have reasoned that they wanted it to appear that the relationship had terminated in order to minimize the liabilities which could stem from its continuation. They maneuvered Rabin into the picture in a manner which would and did give Davis the impression that he was under their tutelage and that they remained Davis'

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nancial responsibility of Goodson and Hannam may well frustrate the benefit that the trial court intended to bestow upon Davis by its judgment.

primary counselors, but which would give them a plausible basis for asserting a termination of the relationship.[10]

(6) Goodson and Hannam assured Davis that, if as his professional advisors and foreseers (as he thought them to be), they should feel that a time had come when the Custom Plan was no longer beneficial to or needed by him, they would find means within the law to put Custom out of business and to cause a return to Davis of the assigned patent interest and a transfer to him of any assets left over after the winding up and the making of a fair provision for those who had been Custom's minority shareholders. (As indicated in our nomenclature paragraph, for the sake of brevity we will use the term "means for reverter" as an abbreviation for this concept.)

It is felt that the proposition that Goodson and Hannam's stock ownership was strictly to enable them to operate Custom advantageously for the Custom Plan and that Goodson and Hannam under proper circumstances would find a means for reverter were deducible by the trial court from the material in the record which is set out in the indicated footnote.[11]

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[10] The procurement of an attorney other than Goodson and Hannam pursuant to their direction could have been considered by the trial court as a demonstration of the fact that Goodson and Hannam had assumed a position which weakened their ability to render full legal service to Davis. Incidentally, this procedure undoubtedly cost Davis some money he otherwise would not have had to pay out, because, if Goodson and Hannam had performed the service, although the process would have reduced Davis' royalties some (by being expensed to Custom), Goodson and Hannam would have been compensated through Custom.

[11] Goodson and Hannam said that they "would hold the stock, and they would own it." ¶ Goodson and Hannam said that they

(This footnote is continued on next page)

Goodson and Hannam had no intention of keeping such surveillance or of carrying out such a means for reverter under any circumstance; rather, they intended to foster Custom's continued existence with reducing adherence to the Custom Plan ensuring maximum value of their stock which they were prepared to claim was

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"would . . . run the stock" of Custom, "being the company not owned by me"; meaning, apparently, that they would run Custom, so as to make the Custom Plan work to the benefit of Davis. ¶ Note that May testified that Goodson and Hannam wanted 51 percent of the Custom stock "so they could operate that company and see that at all times . . . Davis was fairly treated." Even Goodson and Hannam testified that Davis wanted control of Custom in the hands of men whom he knew, and that "[we] presumed he trusted us." ¶ Davis testified: "I presumed . . . that this [apparently referring to the stock owned by Goodson and Hannam and residual Custom assets] would revert to me at such time as [Goodson and Hannam] saw fit, when it looked [to them] . . . acceptable [legally] and desirable to make a change in the [Custom Plan]." The trial court could have inferred that Davis' presumption arose from an explanation given to him by Goodson and Hannam. There was no objection that Davis' testimony amounted to a conclusion. ¶ With respect to the Custom stock, Goodson and Hannam said, "in effect" that they "would . . . own it and return it at such time as [they] saw fit." ¶ Davis affirmed that Goodson and Hannam made him believe that he could not have an indirect stock interest in Custom. ¶ Davis testified that he could not recall that Goodson and Hannam in their statements to him had used the phrase that they would hold the Custom stock in trust. The trial court, of course, could determine from that testimony that Goodson and Hannam had not used any such phrase. ¶ Goodson and Hannam stated that "they would hold the [Custom] stock [and] operate the company." ¶ Davis testified that he presumed from what Goodson and Hannam said that "this" would revert to him automatically when Goodson and Hannam considered it desirable and acceptable. ¶ What Davis considered was to revert he explained as "everything". It seems quite clear that Davis meant by this term the undivided one-half patent interest and the residual Custom assets. Davis explained that the means of effecting the reverter would be the default process he had mentioned, deliberately initiated; but he moved from the specific to the general by adding that he did not know how the reverter was going to be accomplished and that Goodson and Hannam "were going to work it out." As to the time when the reverter might occur, Davis gave an indication by making reference to "on going patents which would make this program run into the future, so it would be maybe their attorneys' fee; and, eventually to capitalize on the residual value thereof.

Unfortunately, it appears, in light of supportable trial court views, that Goodson and Hannam permitted the lure for personal aggrandizement to obscure what should have been their unflagging perception of and

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some time before we would ever get to that [reverter process]." Otherwise, Davis understood that any time that it was desirable, Goodson and Hannam would make (the business) revert. ¶ Davis further testified that he would not split his company (meaning, it is felt, the marketing potential of his devices) if he had not expected that it would recircle in the long run. Davis put it that in his estimation whether this expectation (which the trial court could have considered as stemming from loosely made unilateral representations by Goodson and Hannam) made the stock in Custom (and thus, indirectly, Custom itself) his property was a legal determination. ¶ Davis testified that he knew that he did not own any of the stock of Custom. ¶ Goodson and Hannam told Davis that they were going to hold the stock and that the stock issued to Humphrey would have a repurchase clause, a feature which Davis interpreted as an aid to ultimate reverter. ¶ Davis testified that he was not worried that others than Goodson and Hannam had stock in Custom. He pointed out that Goodson and Hannam had stated that there would be a stock repurchase agreement with May as well as with Humphrey. Davis felt that even if May held stock, Goodson and Hannam were in control. It was Davis' understanding that if the Custom Plan were scrubbed, May would be paid on some acceptable basis. ¶ Referring to the interest which the shareholders of Custom had, Davis observed that he guessed it was an ownership. ¶ Davis testified that he understood that the Custom Plan was a plan for him and if there was anything he did not like about it, Goodson and Hannam "would work it out." This concept, it will be noted, is not so drastic as to say that if Davis announced at any time simply that he did not like the operation of the plan, it would be scrubbed and everything would come back to him. Thus, the point is still viable that Davis placed great reliance on the professional loyalty, ingenuity and foresight of Goodson and Hannam. ¶ Davis testified that he knew that he had to sell a one-half interest in his patents, but he understood that Goodson and Hannam were going to return it when they felt the plan had served its purpose. ¶ Goodson and Hannam claimed that they discussed possibility of reverter with the R. Bd. It is doubtful that the trial court believed this; but the fact that Goodson and Hannam brought this up suggests their concession that they had made representations to Davis about it.

attention to the interests of Davis and to cloud their appreciation of the extent of the fiduciary and professional loyalty and obligation owed by an attorney to his client.[12] It was the duty of Goodson and Hannam, as the acting attorneys for Davis, to obtain for Davis every advantage they could and to avoid at any point placing their own interests ahead of his. (*Meinhard v. Salmon* (N.Y. 1928) 164 N.E. 545; *Eschwig v. State Bar,* 1 Cal.3d 8, 16; *Clancy v. State Bar,* 71 Cal.2d 140, 146-147; *Radner v. Trasher,* 57 Cal.2d 244, 249-250.)

Clearly this conduct constituted a violation of the Goodson and Hannam trust position (*Trafton v. Youngblood,* 69 Cal.2d 17, 27; *Rebmann v. Major, supra,* 5 Cal.App.3d 684, 688; *Gold v. Greenwald,* 247 Cal. App.2d 296, 306-309), and of the high duty standards attendant to the relationship of attorney and client and amounted to fraud[13] providing the trial court with the authority, in fact imposing upon it the obligation to declare a constructive trust on their 60 ⅔rds percent of Custom stock. (*Redke v. Silvertrust,* 6 Cal.3d 94, 106; *Day v. Greene,* 59 Cal.2d 404, 411; *Ehret v. Ichioka,* 247 Cal.App.2d 637, 642-643.)

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[12] We cannot say that the trial court was not justified in taking the position, which it manifestly did, that when Goodson and Hannam told Davis that the best thing that he could do was to get ail he could into Custom (so that 65 percent of Custom's net profits would come back to him in capital gains), they had more in mind the idea that this build-up of the business for Custom would make the pot so much bigger for themselves than the thought that it would benefit Davis. The same is to be said as to Goodson and Hannam's advice to Davis that it was necessary that he furnish tools, know-how, and personnel to Custom and to get customers to release existing contracts with and commitments to Hydra and place them with Custom; that is, their motive was as much to increase the stake for themselves as it was to insure the successful operation of the Custom Plan.

[13] Because of the actual fraud finding, undue influence and lack of consideration became a secondary feature. However, the trial court had ample basis for taking the position that at the time the renegotiation problem of Davis came up, Goodson and Hannam were his attorneys, having recently worked out the fragmentation of Hydra and counselled him concerning personal estate matters and being considered by Davis as his attorneys for dealings with the government. At least the influence of Goodson

The purpose of the constructive trust would be among other things: (1) to remove Goodson and Hannam from their undeserved position of control in connection with the Custom Plan, (2) to take from them anything of value[14] gained through their perfidy (prevent unjust enrichment of the defalcating constructive trustee, which is the paramount concern of the courts, not damage to the constructive beneficiary) (*Amen v. Black* (10 Cir. 1956) 234 F.2d 12, 21), and (3) to put Davis in a position to make derivative claims for the misapplied corporate funds and to cause

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and Hannam acquired by the recent attorney and client relationship remained. (See section 2235, Civ. Code.) Goodson and Hannam, through their position as the attorneys to whom Davis looked to and trusted, had the ability to influence him. The trial court was entitled to decide that Goodson and Hannam proceeded to exert this influence too strongly to obtain an advantage from Davis contrary to the command of section 2231. Section 2234 of the Civil Code states that this violation was a fraud against Davis. Because of this, the imposition of a constructive trust to ameliorate that fraud was a proper equitable device for the trial court to employ.

Goodson and Hannam, of course, gave no consideration to Davis for taking more out of the Custom Plan than was planned. Also, the trial court could consider that Goodson and Hannam had put Davis into a plan which the latter thought could be modified or scrubbed legally when it was no longer advantageous to Davis, but which Goodson and Hannam well knew could not be done without great difficulty and hazard and did not intend to aid in accomplishing in any event. Thus, there was insufficient consideration for Davis because he did not get what he bargained for.

[14] Only the stock was reachable; the dividends apparently had been dissipated, otherwise the traceable residuals would have been an object of the constructive trust rather than of a damage award.

Custom either to dissolve subject to such opposition as the minority shareholders might interpose or to deal with himself as to the continued operation of the Custom Plan, its interpretation, reformation, modification or termination, subject to any counter derivative moves that the minority might be able to achieve.

The primary and fundamental attack of Goodson and Hannam against the breach of fiduciary duty and constructive trust aspect of the judgment is that Davis' trial court story most favorable to himself is unbelievable and can and should be rejected as such by this court even though the trial court believed it. The Davis version is unbelievable, they say, because it is inherently improbable that Goodson and Hannam would have spoken, acted and (inferentially) thought as Davis related and because Davis was caught in inconsistencies in his in-court and deposition testimony in the instant case and in a contradiction to both in a statement read into his Cook deposition. The factors of inherent improbability and of impeachment were for the trial court. (6 Witkin, Calif. Proc., Appeal, § 251, p. 4242; *Bechtold v. Bishop & Co., Inc.,* 16 Cal.2d 285, 291; *People v. Wilburn,* 195 Cal.App.2d 702, 706; *Estate of Pelton,* 140 Cal.App.2d 512, 515-516.) The appellate court cannot make its own evaluation of credibility, even though to some the evidence would have seemed so unbelievable as to compel a contrary judgment. (Witkin, *ibid.*) Seemingly, a rare variance from this fundamental rule is recognized. *Evje v. City Title Ins. Co.,* 120 Cal.App.2d 488, 492, cited by Witkin, suggests that this is when the testimony rejected by the reviewing court is "wholly unacceptable to reasonable minds" or "unbelievable *per se.*" (Apparently these descriptive phrases mean something more than inherently improbable.) We do not feel that the Davis testimony is in the *Evje* category.

We consider a few significant examples. Goodson and Hannam argue that it is unbelievable as a matter of law that they assured Davis that they would continue as his professional advisors and foreseers; that they would, when the circumstances permitted, find a means for reverter;[15] that they would be satisfied with reasonable salaries from Custom as their remuneration and would not charge any attorneys' fees for working out the Custom Plan and rendering succeeding services, because if the former had been part of the arrangement, it would have been vulnerable to government attack and if the latter had been carried out, it would have constituted economic suicide on their part. However, these examples assume forthrightness on the part of Goodson and Hannam, an attribute the trial court found in want. Moreover, the testimony of the experts, as discussed more fully later, did not establish that the mentioned factors would doom the Custom Plan, and Davis brought out that Goodson and Hannam had not been long at the practice of law and were of modest worth, were "young and hungry" as the trial court put it.

Neither the "lock, stock and barrel" testimony in the instant deposition (which is the strongest example and the one continually stressed by Goodson and Hannam) nor the assertion of *no interest* found in the Cook statement are necessarily incompatible with Davis' trial court position. The former was given after suit had been filed and when Davis no doubt was aware of the doctrine of constructive trust in rectification of breach of fiduciary duty, and it can be rationalized as a layman's way of putting that concept.[16] It is true that Davis answered in the affirmative to the query if that was how he felt in 1957, but he added the qualification "in the way I've just explained it to you." The trial court could have considered that what Davis meant by these qualifying words was that if he had known in 1957 about Goodson and Hannam what he does now, he would have felt the same constructive trust type of proprietorship and would have been acting on it. At the time of the Cook deposition, a different angle was under exploration and Davis was under the tutelage of Goodson and Hannam. They, themselves, testified that the strategy was to emphasize business reasons (for the patent assignment) and only to go into the tax and then the renegotiation features if the questioning called for it.

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[15] It seems to be the argument of Goodson and Hannam that the story that they represented that they could achieve a means for reverter within the technicality of the law cannot be believed because it is out of reason that Davis would have attributed that much ingenuity to Goodson and Hannam. However, such a belief by Davis is not at all improbable considering his observance of and feeling about the Hydra fragmentation. Certainly his conception would not have been shaken, but rather fortified, had he been able to foresee the maneuvers pursued to retain the Convair order as a Custom project.

In any event, the trial court was not required to hold Davis to occasional unfavorable fragments of his testimony or to disbelieve his trial version, even though it felt that he had not told the absolute truth in the Cook deposition. (*Estate of Pelton, supra,* 140 Cal.App.2d 512, 515-516: "The trial court . . . was not obligated to disbelieve the testimony given by the witnesses at the trial, because of their admissions of perjury in their depositions. It was the exclusive province of the trial court to winnow the grains of truth from the chaff of falsehood in the testimony of these witnesses, and its determination of what was true and what was false cannot be reviewed by this court." See also, *Holman v. Viko*, 161 Cal.App.2d 87, 99.)

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[16] Or a verbalization of an instinctive reaction as to what perfidy on the part of his trusted attorneys would bring about.

IN PARI DELICTO DEFENSE

Since we have concluded that the trial court's belief in the testimony of Davis and disbelief in that of Goodson and Hannam is to be sustained, we consider Goodson and Hannam's alternate defense. They argue Davis' disentitlement to the aid of the court due to illegality with optimistic conviction. This agreement postulates that there was indeed a dummy shareholder set-up which made the claim of separate control a fraud on the government for which Davis should be held accountable either because of conspiratorial concealment or of basic illegality.

We have already determined that the trial court was not required to and did not adopt that interpretation of Davis' testimony. It remains, nonetheless, to determine if the illegality contention applies to Davis' means-for-reverter version.

Such a concept was not included in the hypotheticals submitted to the R. Bd. and the I.R.S. to obtain rulings. But there was no representation to the agencies that the program ultimately adopted would conform; and there was no requirement that the parties follow the hypothetical plan, or, specifically advise the agencies if they made any variations. As Goodson and Hannam put it, the obtaining of rulings was to set principles. This also was the feeling of the experts, Page and Kragen. The tenor of the expert testimony indicates that the governmental agencies did not particularly expect that there would be conformance to the hypotheticals and were aware that the contractor could be setting up a varying plan which he felt was still properly within the principles but which the government might not. It is a matter of judgment on the part of the contractor whether any changes individually or in combination have caused his program to approach a common control situation.

Nothing in the record on the point of how close the means-for-reverter concept, in the setting of the other features of the Custom Plan, put the plan into a common control situation is of a positive nature.[17] The testimony of Kragen, Page and Pavitt was essentially noncommittal and in some respects favorable to Davis. As the testimony of Page suggests, it is the type of thing where the client is entitled to trust his attorney's evaluation.

Page testified in effect that one got into an imponderable when considering an arrangement for a reverter. He spoke of the desirability of making a flexible plan so that the client would not suffer a forfeiture in the event of a change in circumstances. He indicated that one could set how long whatever plan was put into effect would be operable, stressing that the renegotiation inquiry was a year-to-year thing. He pointed out that the renegotiation law was subject to change at any time, and that one would have no control over whether a plan would be in conformity say five years hence. He left the inference that there was nothing amiss in anticipating this with at least the concept of meeting such change with modifications or even with the scrubbing of a plan if that were so indicated. When asked, in effect, whether it would be appropriate to have a provision for reverter if a change in law made a plan no longer effective, he said no more than that this would present a question, and indicated (obviously to avoid the possible involvement government examination of the agreement might bring) that he would just advise the client that if the law changed he would then make whatever arrangements he could to aid the client. He put it that the less there was in the agreement, the more flexibility there would be for meeting contingencies, saying that if one can trust the person with whom he is dealing, he is better off not being too specific about protections. This was close to the Davis version of Goodson and Hannam's proposal—in effect, the assurance that if the situation warranted and allowed it, through their resourcefulness and ingenuity, they would find a way to scrub the plan, return the patent interest and transfer residual assets. The trial court was warranted in concluding that Page did not consider such an approach unforthright. Page referred to *Southland Steel v. War Contracts Price Adj. Bd.* 13 T.C. 652, a family relation tie-up, wherein a finding of common control by the R. Bd. was reversed by the tax court. This decision would indicate that some features seemingly indicative of common control might be found not to be such and would lend justification in many instances to a contractor acting on the premise that his plan is defensible. Finally Page recognized the use of the vendor's lien to assist in the process of an engineered reverter, and he recommended low cost licensing to a third party in the case of a recalcitrant Custom.

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[17] We note that during about two years when May owned all of Proportioners, Goodson and Hannam supervised returns to the R. Bd. which in effect represented that Proportioners was not under common control with Switches, even though it owed May $32,000 and was still the beneficiary of some of his guarantees.

The tenor of Kragen's testimony is that from the income-tax angle Goodson and Hannam's means-for-reverter assurance would not have made showing royalties as capital gains on a tax return an illegal act. In particular, he testified that under Internal Revenue Code, section 1235 (26 U.S.C.A. § 1235) Davis could have held stock in Custom and had a security interest in and right of recapture of the assigned patent interests. Neither, according to him, would it have been a fraud to fail to disclose in tax returns the royalty duration intent. Apparently this would be on the basis that there would be a fair difference of opinion whether the Custom concept in the future would cause some portion of the royalty payments to be classified as ordinary income. Kragen also testified that the government looked at the situation year by year and not overall.[18]

It is true that Pavitt testified that one could not create, "a sham transaction where you put it out and then pull it back"; but this seems to relate to a secret express trust either as to the patents or as to Goodson and Hannam's Custom stock. On the subject of a means for reverter, Pavitt's observation was that "these agreements not to continue in business or to get out are always very dangerous in writing", suggesting that the unilateral oral assurance of finding a means for reverter at the appropriate time does not lack propriety.

To us, this particular issue boils down to whether there was a failure to follow governmental requirements in connection with the filing of R. Bd. forms, and, if so, whether the deceit involved, so far as Davis is concerned, was so aggravated that the court will not weigh culpability as between him and Goodson and Hannam, but leave them as it finds them.[19]

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[18] Incidentally Kragen testified that the furnishing of technical data by Davis to Custom would have had no effect income-tax-wise.

The forms, RB 90 (statement of nonapplicability) and RB 1 (standard report) leave it up to the contractor to say whether he is under common control with another. If he says "yes," he is to supply a brief explanation. The instructions for RB 1 caution that whenever any possibility of common control exists, the facts should be disclosed; but the form is not set up that way, and the tenor of the testimony of Page suggests that the practice was to follow the form and give details only when the contractor felt that he was under common control.

It was, of course, the duty of Goodson and Hannam to formulate such a plan that it would not bring about a violation of requirements to submit a form which did not contain a recital of common control or an explanation of circumstances indicative thereof; and Davis had the right to rely on their doing so. It was not said by Goodson and Hannam that they hinted to him that they had done otherwise. He testified that he thought the plan was legal and that he had no idea that any fraud was involved. When asked if Goodson and Hannam had told him that the R. Bd. had taken the position that there could be no right of recapture, he responded that he did not recall that at all. Davis further testified:

> "[I]f I were to make a conclusion, it was that [Custom] couldn't be a sham company, yes. [¶]

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[19] The situation was not as if the R. Bd. and I.R.S. had challenged the Custom Plan because of knowledge of the means-for-reverter assurance and Davis resisted, and a court decision had to be made one way or the other on legality.

> I had to follow the law, whatever the law was, and that is what we did, ..."
>
> "[I]t [the Custom Plan] was [Goodson and Hannam's] proposal [,] and I accepted it."

Davis also testified that it never occurred to him that there would be a fraud problem, and that "[w]e followed the rules, whatever they were."

Initially the preparation of the R. Bd. forms was under the supervision of Goodson and Hannam and their execution by Davis was under their influence and tutelage. There were several variances in the ultimate Custom Plan, aside from the means for reverter, which might or might not have been classifiable by a conscientious contractor as pointing toward common control. Goodson and Hannam have not urged that there was any fraud in not revealing these. If there was any impropriety in the form filling, Goodson and Hannam were the contrivers thereof. Considering how Goodson and Hannam emphasized to Davis that they owned the stock, that he had no control over Custom, and that they would seek means for reverter only if circumstances called for and allowed it, there was no reason for Davis to suspect that the forms were deceptive to the government.

Nonetheless in our opinion the government, under its instructions, was entitled to an explanation of the Custom Plan on the thesis that Goodson and Hannam's stock ownership, the duration of the royalty obligation, the royalty percentages, and the collateral assurance of means for reverter, taken together, did pose a possibility of common control.

If there had been a disclosure, it would remain an open question whether the R. Bd. would take the stand that there was common control or even would request a showing of justification against the possibility. As we see it, there is no cause for us to enter this alien field to make a determination ourselves. It is enough for us to appreciate that it is no dead certainty that the R. Bd. and the tax court would consider that there was common control; that Davis had an arguable position. The gravamen of the fault is not meeting the requirement of making known the potential. Under those circumstances matters would not have worsened by the fact that there would follow an adverse adjudication. We do not sanction the nondisclosure, but we do explicate the subordinate involvement of Davis. It was not such as to require a solicited court to refrain from intervening to aid Davis as the victim of Goodson and Hannam's wilful breach of professional duty as found by the trial court. The situation is close to that found in *Clark v. Millsap,* 197 Cal. 765. (See also *Sontag v. Denio,* 23 Cal.App.2d 319 and *Young v. The Young Holdings Corp., Ltd.,* 27 Cal.App.2d 129, 151.) It should be governed by its principles. *Perma Mufflers v. Int'l Parts Corp.,* 392 U.S. 134, 140-141 (reviewed in Schiebelhut, *Demise Of In Pari Delicto,* (1972) 60 Cal.L.Rev. 572) discloses the disposition of the United States Supreme Court to subordinate the defense of In Pari Delicto to doctrines of more significant value which, in our instance, would be that of the high professional fiduciary duty which an attorney owes to his client.[29] (Compare *Smith v. Turner,* 238 Cal.App.2d 141, 148-153; *Tri-Q Inc. v. Sta-Hi Corp.,* 63 Cal.2d

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[29] Compare the threat of private action supplementary to the example of State Bar proceedings as a vehicle to encourage adherence to lofty professional standards with the threat of private action, in the trade-restraint and corporate securities situations, as a vehicle to foster public benefit through competition and equality of disclosure.

199, 218-219 and *Norwood v. Judd*, 93 Cal.App.2d 276, 288-289.)

Both sides have claimed comfort from *Redke v. Silvertrust*, 6 Cal.3d 94. We believe that its rationale aids Davis.

The main point of Redke for us is the Supreme Court's position, under circumstances somewhat similar to ours,[21] that the naive beneficiary will not be barred from recovery from the designing fiduciary on the ground of a public policy to deter others who are, in fact, mutually culpable. For providing additional elucidation on this point and for showing further instructive aspects of the case, we give our detailed analysis and comparisons in the indicated footnote.[22]

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[21] A deception exercised against the government when the wrongful act is contrived by one (in *Redke* through whom resistor claims) owing a fiduciary duty to another (in *Redke* through whom claimant seeks to take) with the fiduciary being sophisticated and the beneficiary unsophisticated in the involved field whereby the beneficiary gains value and the fiduciary usurps part.

[22] In *Redke*, Mitzi sought to have the court determine that her stepfather, Sam (and so, on his death, his estate), became constructive trustee for her (Mitzi) of the property willed to him by his wife, Ann (Mitzi's mother), because Sam's repudiation of his promise to Ann to exercise in favor of her daughter, Mitzi, the unlimited power of appointment given to him under Ann's will constituted a violation of the conjugal fiduciary and confidential relationship between husband and wife, a species of constructive fraud, which justified the imposition of a constructive trust. (Pp. 100-101.)

Sam's estate urged that this should not be done because, on notice to Ann, Sam's promise to appoint to Mitzi made their plan to get the marital deduction (which Sam did get) by an apparent unlimited power a fraud against the government.

> By way of comparison, Goodson and Hannam are saying that the court should not make Davis constructive beneficiary of the Custom stock because, on notice to Davis, the failure to give an explanation of indicators of common control in the R. Bd. forms was a fraud against the government.

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The holding that Davis is not barred from recovery against Goodson and Hannam is subject, of course,

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What the Supreme Court is saying in *Redke* is that there was evidence accepted by the trial court that Ann had no appreciation, by which Mitzi would be bound, of the illegal aspect of the understanding between her and Sam, and, further, that it is not to be ruled that, despite this innocence of Ann, Mitzi will be barred from relief on the ground of a public policy to deter other husbands and wives from working out such an arrangement, by making it plain that if one finds that the other has been untrustworthy, he cannot gain court assistance against the other by falsely claiming innocence of the fraudulent aspect against the government.

> Again by way of comparison, in our case, Davis was seeking to have the trial court determine that his attorneys, Goodson and Hannam, became constructive trustees for him of the Custom stock which they got by reason of his acceptance of their Custom plan under circumstances wherein Goodson and Hannam were guilty of fraud which constituted a violation of the professional fiduciary and confidential relationship between attorney and client.
>
> Goodson and Hannam are urging that this should not be done because the means for reverter concept made the filing of the R. Bd. forms a fraud on the government.
>
> In effect, the trial court in the instant case has said that there is evidence that Davis had no appreciation that there was any such fraudulent aspect and further that the law should not be that, despite Davis' innocence, he will be barred from relief on the ground of a public policy to deter other lawyer-client combinations (wherein both have fraudulent scienter) from acting similarly, by making it clear that if the client finds that the lawyer turns out to be unfaithful, he cannot gain court assistance against him by claiming false innocence of a fraudulent aspect against the government.

One instructive part of *Redke* is the principle that the violation of a confidential and fiduciary relationship insures the remedy of imposition of a constructive trust. (Pp. 100-101.) In *Redke*, the violation was considered a constructive fraud.

> In the instant case, by the award of nominal punitive damages, the trial court made it known that it was finding actual fraud. Of course, in *Redke*, a statute of frauds problem was raised which has no parallel here.

In *Redke*, it was pointed out, in effect, that Sam could have avoided the effect of any aspect of illegality in the agreement by not claiming the marital deduction or by disclosing the agreement to tax authorities which, no doubt, would have resulted in the disallowance of the marital deduction.

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to his answering to the government on whatever position it should take. From its standpoint, the government

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> In the instant matter, the "understanding" was open to the interpretation by the trial court that there would be ways whereby the major part of the Custom enterprise could be recircled to Davis which would be within the law. Also, it would seem that no illegality problem would arise, if, in connection with such a recircling, the circumstances were made known to the government and Davis was willing to accept whatever retroactive detriments might be imposed by it.

It was also stressed in *Redke* that Ann was a housewife with little familiarity with business transactions, that Sam was the dominant influence in managing the conjugal affairs, that Ann had no reason to suspect that Sam would proceed illegally, and that "'[n]otwithstanding any explanations that may have been offered to her, it is doubtful that Ann had any particular or clear comprehension . . . at any time of the technical aspects of a marital deduction, or an unlimited power of appointment, or [of] the tax laws pertaining thereto." (P. 103.)

> In the instant case it was open to the trial court to consider that Davis was a lay person without sophistication in the indicated field of taxes and government regulation; that Goodson and Hannam were knowledgeable in that area and were the dominant influence in arranging the tax and anti-renegotiation plans; that Davis was under their tutelage when the first renegotiation reports were sent in; and that Davis had no reason to suspect that Goodson and Hannam would proceed illegally. As noted above, Davis testified:
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> "If I were to make a conclusion, it was that [Custom] couldn't be a sham company, . . . ¶ I had to follow the law, whatever the law was, and that is what we did."
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> * * * *
>
> "[I]t [the Custom Plan] was their proposal [,] and I accepted it." Davis testified that it never occurred to him that there would be a fraud problem.
>
> The trial court also could have found that Davis had no idea what was or was not an "indirect interest" in Custom and that he, because of the lack of detailed explanation to him by Goodson and Hannam and of his practice of accepting carte blanche programs recommended by the lawyers he had chosen ("[I]t was a tax plan . . . and I left it up to them." "I didn't, however, expect to approve of anything in particular." "I didn't check the contract to see . . . how it squared with [what Goodson and Hannam were] telling me . . . ." "I don't second-guess important matters, I use counsel."), Davis had no clear comprehension of the technical aspects of the rules about common

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is better off with assets in the hands of the contractor it might consider the true receiver of the profits which

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control and capital gains and of how the Custom Plan met them and what the loose understanding dehors the contract about reverter under appropriate circumstances would affect the defensibility of the plan.

The Supreme Court in *Redke* (at p. 103) pointed out that although a guilty state of mind on the part of Ann could have been inferred, it was not, and observed: "As noted in *Platt v. Wells Fargo Bank*, . . ., 222 Cal.App.2d 658, 664, questions of 'intent' and 'purpose' are ordinarily questions of fact to be determined by the trial court." It then alluded to the trial court's findings as to Ann's state of mind, including the fact that it was Sam who counselled her, that Ann had little knowledge of business transactions or tax laws, and that Ann entrusted Sam with the responsibility of managing her affairs.

> In the instant matter implicit in the trial court's findings and supported by the overall tenor of the evidence, is the fact that it was Goodson and Hannam who counselled the Custom Plan, made the representations about recycling, and supervised the compilation and execution of the annual reports to the R. Bd.

It is significant that in *Redke,* if the plan of Ann and Sam was that the latter would take the marital deduction and then would commit himself to willing all Ann's property to Mitzi under his unlimited power of appointment, the agreement undoubtedly was illegal.

> In the instant matter, the loose understanding for an ultimate reverter under appropriate and allowable circumstances at the most would have required an explanation of that understanding in the forms to be filed. There would only have been illegality if Goodson and Hannam and Davis had schemed not to reveal the understanding even if they felt that the regulations were interpretable as requiring it. Actually, in one sense, there was no agreement as such, rather, there was a unilateral indication by Goodson and Hannam, which Davis thought was reliable, that they, in the spirit of their professional devotion to his interests, at some appropriate time in the future, would devise a process to get back to Davis a substantial portion of any accumulated assets of Custom and the marketing potential of his devices. By imposing a constructive trust, the trial court was not enforcing a bargain between Davis and Goodson and Hannam (and certainly not between Davis and Custom) but, rather it was, as a means for rectifying constructive fraud, dislodging Goodson and Hannam from the advantage they had gained in failing to ad-

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it feels are renegotiable and ordinary income in character.

Since this opinion is not being published and the governmental agencies will not have that means of knowledge of its contents, the trial court, in the exercise of its equitable powers may wish to see that copies of this opinion are made available to the I.R.S., the R. Bd., and the Franchise Tax Board.

STATUTE OF LIMITATIONS

The essence of the contention of Goodson and Hannam under this heading is that awareness by Davis of the contents of Goodson and Hannam's June 1961 memorandum (Exhibit R) and of discussions between Goodson and Hannam and Rabin on its subject matter should have put him on inquiry.[23] (Civ. Code,

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here to the high standards of their profession and to the strong duty of loyalty to the interests of their client.

With respect to the matter of policy, we note the following language in the *Redke* opinion (at p. 104):

> "Defendants also urge that regardless of Sam or Ann's intent, all such oral agreements should be declared void as against public policy, in order to deter others from attempting to evade death taxes from such a device. We cannot so readily assume, however, that other persons will be induced to violate the tax laws in this manner, or that the taxing authorities will fail to discover their fraud. [Footnote omitted.]"

The omitted footnote points out that there is no limitations period on actions by federal taxing authorities involving fraudulent attempts to evade taxes.

Thinking in terms of the instant case, it may well be that the same rule would apply to renegotiation matters.

[23] At trial it also was urged that Davis should have been alerted to duplicity on the part of Goodson and Hannam by awareness of Custom's indulgence in research (indicating movement away from Custom Plan) and exposure to the Proportioner manipulation (indicating position of absolute proprietary interest). However, until after suit was filed defendants made no pretext that Custom was processing any new type of product upon which it

§ 19.) The memorandum contained material of neutral, beneficial and detrimental cast—a proposal for royalties on profits of subsidiaries; a recommendation for study of uncovered licensing problems; a suggestion that any revised agreement be reviewed by patent counsel; and a proposal for reduced royalty percentages above certain gross totals. In November 1965 something along the line of the last proposal, perhaps more emphatically put and uncoupled with compensating benefits, apparently did lead Davis to inquiry through Keatinge.[24] Where a fiduciary relation or its enduring influence pertains[25] (as the trial court found here) obviously there is less cause for suspicion and no duty to reexamine the circumstances (*Hobart v. Hobart Estate Co.,* 26 Cal.2d 412, 440). The law does not require one to suspect his fiduciary. The statute of limitations is not intended to impose on a defrauded party the burden of discovering a fraud perpetrated by one standing in a position of trust and confidence. (*Amen v. Black,* 234 F.2d 12, 21, 26.) (See also *Black v. Riley,* 20 Cal.App. 199, 202 [it is only when attorney assumes hostile attitude that client cannot assume attorney's fidelity and dedication to client's interests]; *Rutherford v. Rideout Bank,* 11 Cal.2d 479, 486 [where fiduciary relation pertains, facts which ordinarily require investigation may not excite suspicion];

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did not have to pay royalty; and the Hydra fragmentation had accustomed Davis to maneuvers of the Proportioner type and anyway it was accomplished to meet a renegotiation problem.

[24] It is apparent that something transpired at this meeting which was illuminating to both Davis and Goodson and Hannam, because Goodson and Hannam testified that they tied the Keatinge call back to the November meeting.

[25] Not to be overlooked is that Goodson and Hannam indicated that "their [operations through] ownership of Custom would constitute rendering [continuing] legal service to Davis in connection with the [Custom] [P]lan."

Barron Estate Co. v. Woodruff Co., 163 Cal. 561, 576 [victim may justly rely on good faith of guilty party]; *Laraway v. First Nat. Bk. of LaVerne*, 39 Cal.App.2d 718, 728-729 [where confidential relation exists one can act on presumption of absence of intent to defraud]; see further, *Anderson v. Thacher*, 76 Cal.App.2d 50, 70 and *Kornbau v. Evans*, 66 Cal. App.2d 677, 685-686.) We are not prepared to say that no other reasonable conclusion could have been reached than that, in its then setting, the proposal was sufficiently startling to put a prudent man in Davis' shoes upon inquiry. We do not have to.

The trial court was not required to find actual awareness on the part of Davis. For that the situation would have to have been that no reasonable deduction was open to the trial court other than that Rabin would have advised Davis of the memorandum's contents. We cannot so hold. Davis said that he knew about some conferring but not what it concerned. It was open to the trial court to consider that Rabin felt that he was working under Goodson and Hannam, that they were just exploring together, that absent a direction from Goodson and Hannam there was no need to lay details before Davis. The trial court let it be known that it was influenced by the fact that Westbrook had Rabin in court but never called him on this or the change of counsel point. It was entitled to draw inferences adverse to Goodson and Hannam.[26]

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[26] Thus, Westbrook did not question Rabin on the topic of whether Davis had made known to him earlier than November 1965 that he entertained suspicions that Goodson and Hannam were fostering their own interests instead of his. The record indicates that Rabin was the subject of discovery proceedings. The trial court no doubt surmised that the process had produced nothing of that nature.

(*Masterson v. Pig'n Whistle,* 161 Cal.App.2d 323, 338; *Talbert v. Ostergaard,* 129 Cal.App.2d 222, 229; *Martinez v. Superior Court,* 7 Cal.App.3d 569, 576 (questioned on another point in *Mozzetti v. Superior Court,* 4 Cal.3d 699, 703).) Incidentally, it was Davis' testimony that he had not told Rabin what representations had been made to him by Goodson and Hannam. Further, Davis stated that until November 1965 he thought that the situation was "in good hands" (Goodson and Hannam's) and being taken care of, and that "everything was going perfect."

Goodson and Hannam urge that the trial court was bound to apply the rule that information gained by an attorney is to be attributed to his client. Their contention, however, is premised on the proposition that it was recognized by all that by then Rabin was Davis' independent counsel. The rule, of course, is patterned to such a situation. In our view it should not be applied to the situation wherein the party to be bound considers that the party claiming advantage of the rule is his primary attorney and that the attorney receiving the information is the "satellite" of the other. We cannot say as a matter of law that Davis should not have considered that Goodson and Hannam remained as his primary counsel at least until their overtures in November 1965 gave him an inkling that they were preferring their own interests to his. Davis testified, in effect, that until the break in November 1965 he considered that Goodson and Hannam remained as the so-called masterminds as to the on-going operations of the Custom Plan and as to its continuing efficacy, and regarded Rabin as their subaltern in charge of details and not as his independent counsel. The trial court had the right to believe Davis.[27] Goodson and Hannam, in effect, argue that the trial court had to find as a matter of law that this belief was unjustified. We cannot say that this was required. The evidence shows that Rabin's association started out on the indicated basis. There were no specific events which should have signified to Davis that this pattern was not continuing. The tenor of Davis' testimony allowed the inference that Goodson and Hannam did not tell him that they no longer would act as his primary advisors and foreseers.[28] Davis testified that both worked on the 1961 renegotiation assignment, on an R. Bd. matter in 1962, and on his "foundation"; that there were a number of meetings, 1962 through 1965, of which, inferentially, Davis became aware, where Goodson and Hannam were present with Rabin, and some when Davis was present as well; that in 1964 Goodson and Hannam and Cuneo, on his behalf, discussed another renegotiation matter. The business type contacts discussed in Goodson and Hannam's opening brief are not inconsistent with Davis' concept; rather, although not constituting legal services in a very technical sense, they fortify it. The reasonable mind could say that the appearance of things was such that Davis was warranted in his belief about Goodson and Hannam. Of course, again, Westbrook's declination to question Rabin on this subject (impressions left by Goodson and Hannam) was stated by the trial court, in effect, to be a strong influencing factor.

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[27] On appeal Goodson and Hannam assume the belief. In the trial there was an unsuccessful attack. An obvious effort was made to get Kelley (with whom Davis dealt in the Mammouth transaction) to do so, but he would not testify that Davis had told him that Goodson and Hannam were no longer his professional advisors.

[28] It seems that when the Custom Plan was being worked out there was a tentative exploration of a discontinuance of the relationship, but Davis was emphatically opposed. The inference is that Goodson and Hannam acquiesced. One reasonable construction of this feature is that it fortifies the plausibility of Davis' challenged belief.

Goodson and Hannam flatly assume a termination of their professional relationship to Davis when Rabin commenced rendering services beyond the original audit project, as shown by his billings. This does not automatically follow. The reaction of Davis has got to be involved. Under a separate heading, Goodson and Hannam anticipate a contingent Davis argument to the effect that even if it were found, as a matter of law, that awareness of facts had put him upon inquiry, the statute of limitations was tolled as long as the attorney-client relationship continued, and they urge in opposition the assumed termination. Davis did not need to make the argument.

ASSERTED RATIFICATION

The defense of ratification, which was rejected by the trial court (Finding 34), rests on the fact that Davis negotiated two royalty checks after the November 1965 date when he says he was alerted and commenced inquiry as to whether Goodson and Hannam were fostering their own and not his interests. One was dated April 22, 1966, and the other January 5, 1967. Cited was *Neet v. Homes,* 25 Cal.2d 447 which is keyed to rescission, a remedy which Davis ultimately did not pursue. Moreover, it is not the Davis-Custom contract which forms the chief basis for Davis' suit against Goodson and Hannam. It is the legal service-fee contract. Accepting the royalty checks does not necessarily affirm or ratify the latter agreement.

Incidentally, as between Davis and Custom, as shown by the correspondence, the difference in views was whether the checks were pursuant to contract or in restitution after a rescission. The trial court was warranted in taking the position that each side was protecting its own position and that neither had compromised his or its position.

631.8 RULING AND STOCK RIGHTS

1. *Procedural Aspects:*

Bearing in mind the nature of the pertinent evidence and argument in this area and the terseness of the ruling,[29] it must be considered that the issues covered in the Code of Civil Procedure section 631.8 motions involved both the questions of constructive trust on the stock of the minority shareholders and of stock rights, and that the original announcement of intended ruling was that there was no constructive trust and that all the stock rights agreements were valid. The ruling had to have been made on the premise that Davis had made a prima facie showing which entitled him at least to have a constructive trust imposed on the Goodson and Hannam 60 percent block[30] and that Davis would continue to so prevail which, of course, he did.

The announcement, of course, was preliminary and tentative; the judgment[31] was to be the "decision."[32] (4 Witkin, California Proc., (2d ed.) Trial, § 312, p. 3119, § 313, p. 3119, § 318, p. 3122, § 304, p.

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[29] For example, when Chodos wanted to know if 9 percent of Custom's assets as well as 9 percent of its shares were beyond Davis' reach, the trial court stated: "[The Employee shareholders] have made a motion for judgment of dismissal under section 631.8, and I have granted it."

[30] We do not have to deal with the ramifications which might have ensued had a constructive trust been imposed on all of Custom's assets.

[31] Whether this could have been executed as a final trial judgment as to separate parties while the trial proceeded with respect to the other parties (Goodson and Hannam and Custom, at first directly and then derivatively), we do not have to say.

[32] For awhile, at trial, Beardsley had the erroneous idea that there had been a "decision" which had put May out of the case. He had to shift to the position that the motion was under submission and that no post-motion evidence could be considered without a formal reopening of the issue.

3113.) It remained in abeyance because consideration of the proposed findings and objections, by minute order of May 26, 1970, was put off until the end of the case. The motions were under submission. This meant that the minority shareholders had no assurance that the trial court would not change its mind but that they were entitled to anticipate that no further plaintiff evidence would be received and considered on the matter unless on motion of counsel or by order of the trial court.

From March 16, 1970, to May 20, 1970, the trial court tried the issue of whether Davis would be entitled to a constructive trust either on all of the assets of Custom or on Goodson and Hannam's 60 per cent block. The minority shareholders and their counsel did not participate. At argument the question of stock rights came up again. When Chodos suggested that the minority shareholders, whose counsel were present at that part of the argument, should be heard with evidence and argument on the question of the divestiture of their stock rights, it really was a request that the submitted Code of Civil Procedure, section 631.8 motions be denied and that the minority shareholders proceed with counter evidence. The ultimate trial court action as to the employee shareholders (June 4) was to stand by the original dual grant in their favor. In due course this was covered by findings and judgment. The effect of the trial court's overall action as to May (June 25) appears to have been to sever the issues, stand by the grant of motion as to the constructive trust point, deny it as to the stock rights point, indicate its readiness to receive any evidence and argument May might have to counter Davis' showing, and, finally, when May declined to present any and submitted, make a full trial type decision that May's security right in Goodson and Hannam's stock and his purchase right upon its involuntary transfer were inoperative as to Davis.

2. *May's Stock Rights:*

The gravamen of May's appellate attack against the decision on the stock rights issue is that he did not have due process or a fair trial, or, in any event, the semblance thereof. Our consideration of these points follows:

(1) There is no assurance that the trial court did not give consideration to evidence which it received between March 16 and May 20, which had a bearing; and there are aspects of it which suggest that it would have.[33] The trial court never said it did not consider some of this. Beardsley asked the trial court "[if its] rulings [was] based on all of the evidence thus far," and it said, "Yes, it is."[34] Davis had made no motion to reopen, and the trial court, until this point, had given no indication that it was going to give attention to such matter. It should not have done so. Its proper action at the time was to have advised Beardsley that it would back off and rerule with only the pre-motion evidence as the basis, and then done just that, whatever might have been the result.

(2) The trial court irregularly made an oral statement of its intended decision out of court to only part

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[33] Davis's testimony concerning his contacts with May and detaching himself from intimations of illegal actions appearing in the testimony of Goodson and Hannam which May might have used in an unclean hands argument.

[34] The trial court may have meant that it had utilized the intervening evidence to confirm Davis' prima facie showing of right to a constructive trust against Goodson and Hannam, but it did not need this; and it did not say so.

of counsel which did not include Beardsley. If the announcement of an intended decision is going to be made in an oral statement, it should be "in open court in the presence of all parties who appeared . . . ." (Cal. Rules of Court, Rule 232(a).) The other method for making such announcement is by filing a written statement with the clerk[25] who mails copies to all parties. (Cal. Rules of Court, Rule 232 (a); 4 Witkin, California Proc., (2d ed.) Trial, § 312, p. 3119.) Carrying out this significant step in connection with this issue in this much deprecated fashion was a flaw in the operation of due process.

(3) The indication is strong that the trial court improperly prejudged the stock rights issue as to May which, in effect, it now had pending before it after its virtual section 631.8 denial; that it had made up its mind that May could not come up with anything that would alter its viewpoint; and that its statement of readiness to hear May's evidence and argument was merely a procedural gesture.

When the trial court asked Smith (who had just testified that the trial court had told him on the telephone that it was going to rule that all post-suit agreements were to be invalidated) whether it had indicated to it that that was the ruling or just an expression of intention, Smith stated that it was his recollection that "[the trial court] had made up [its] mind how [it was] going to rule and that [it was] going to protect the record by giving . . . Beardsley an opportunity tc present argument or evidence"; and that it was his conclusion from what was said and how that "any such argument or evidence would be futile." Although later, when asked by Beardsley if it had "any difference of [*sic*] the statements . . . Smith," the trial court stated that "[it] didn't say [it] was going to definitely rule." The trial court never did disclaim the other portion of Smith's account. It is apparent that on June 25 Beardsley felt that it would be futile for him to have offered any evidence, although his abstinence may have been motivated partly by a desire to avoid a waiver of the added evidence point. " 'A trial judge should not prejudge the issues but should keep an open mind until all the evidence is presented to him.' [Citations.]" (*Hansen v. Hansen*, 233 Cal.App.2d 575, 584; see also *Webber v. Webber*, 33 Cal.2d 153, 158.)

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[25] We note that the trial court used this method subsequently.

(4) It is clear from the record that the trial court's judicial mood was affected by the telephone incident and its aftermath and the justifiable shock displayed by counsel. It became sensitive and self-conscious as evidenced by a series of remarks it made not only at the time but intermittently thereafter. We refrain from quoting or characterizing them. Those concerned are throughly familiar with them.[36] We simply point out that they suggest that the trial court was counter reacting to what it realized had been ill advised communications. It may not have been in the judicial frame of mind to afford the parties a fair determination. The unfortunate incident and its immediate aftermath were not conducive to a calm and deliberate adjudication. Determination of an issue without a fair hearing may constitute a denial of due process and reversible error *per se*. (*Spector v. Superior Court*, 55 Cal.2d 839, 843-844; *Estate of Buchman*, 123 Cal.App.2d 546, 559.)

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[36] The reporter's transcript depicts the difficulty of both court and counsel. (See pp. 5108 and 5121-5140.)

At least those results must have been the look of things. Not only the fact of but the appearance of a fair determination is an important factor in the operation of our judicial system and its ability to command the respect and confidence of the public. Although we have not given the details of the trial court reaction identified in footnote 36, we deem it necessary to refer to certain happenings to which we have given particular consideration on the appearance-of-justice point.

On June 3, 1970, the trial court advised counsel that it had indicated to Smith just in the hallway that probably it would rule in the afternoon, but it wanted to go over some more of the transcript. It then stated: "Let's adjourn now to tomorrow morning and I will give you an answer first thing in the morning.

"What I plan to do tomorrow morning is to make a ruling as to the matters that are before me now [which would include the re-raised stock rights issues] and direct Chodos to prepare the order, period."

So the expectations of all, obviously, were to receive an oral ruling in court with all present. Instead, as we have observed, the announcement of intended decision was made during the night to just some over the telephone. Then this further departure from judicial standards occurred: On June 4, at the outset, the trial court stated: "I would like to make a full disclosure as to what has taken place since court adjourned yesterday." It then proceeded to explain that it had telephoned Chodos and asked him about dates on the stock purchase agreements and discussed possible special masters; had called but not reached Beardsley (one very good reason for adherence to the rule of avoiding out-of-court contacts with counsel): and had then called Smith and told him in essence what it had told Chodos. It then concluded: "Now, that, in essence, is what happened last night. I wanted you gentlemen to know this." Then, of course, the testimony of Smith was taken in connection with Westbrook's motion for mistrial, and it was made known that the trial court had expressed itself on the merits, made comments about some of the attorneys, and advised how it was going to rule and protect its record. Included was the remark, according to Smith, that "[it] would deny [making] the statement if it were quoted" but "[it] was convinced that Goodson and Hannam had taken . . . Davis."

"[O]ur system of law has always endeavored to prevent even the probability of unfairness . . . . [T]o perform its high function in the best way 'justice must satisfy the appearance of justice.' [Citation.]" (*In re Murchison,* 349 U.S. 133, 136.) *Murchison* is a criminal case, but the same principle has been expressed in civil proceedings. " 'The trial of a case should not only be fair in fact, but it should also appear to be fair' [citations]." (*Hansen v. Hansen, supra,* 233 Cal. App.2d 575, 584.) "[I]t is not merely of some importance but is of fundamental importance that justice should not only be done, but should manifestly and undoubtedly be seen to be done." (Hewart, Lord, *Rex v. Sussex Justices,* 1 K.B. 256, 259; see also *In re Gault,* 387 U.S. 1, 26; *Offutt v. United States,* 348 U.S. 11, 14; *Wong Yang Sung v. McGrath,* 339 U.S. 33, 42; *Lois R. v. Superior Court,* 19 Cal.App.3d 895, 902; *Gloria M. v. Superior Court,* 21 Cal.App.3d 525, 527.)

Davis argues that May waived the defects we have reviewed when he submitted the issue on June 25. We note the following: On June 4, when the facts had come out, Beardsley stated that he thought that the trial court had disqualified itself by its conduct. He said that if the trial court set a date, he would be there, but that his motion would be to have "[w]hatever attack has been made on these agreements" "heard by another judge." On June 25, when the trial court called the matter, Beardsley stated that he was not certain how to proceed. He did not reiterate his prior conviction that the trial court was disqualified, and he did not move to have the matter referred to another judge. When, upon inquiry, the trial court affirmed that its June 4th ruling was based on all the evidence thus far, Beardsley said that he did not want to offer any evidence and would submit the matter of May's stock rights. Perhaps under some circumstances this action would have constituted a waiver of the claim of lack of fair trial or semblance thereof, but the trial court's conduct was a sufficiently fundamental departure from proper judicial standards to place it, when combined with the other errors, beyond the reach of this type of waiver. (*Shippey v. Peninsula Rapid Transit Co.*, 197 Cal. 290, 295; *Wuest v. Wuest*, 53 Cal.App. 2d 339, 345-346.)

3. *Purchase Rights in Employee Shareholders' Stock:*

The rights in which we are interested are the so-called options to purchase upon involuntary (though possibly voluntary) termination of employment. The rights of two are involved: Custom (right of first refusal) and the owner of the 60 percent block (right of second refusal). Because of this, Davis actually is making two types of claims. One is on a derivative basis for Custom (initially as contingent, but ultimately as adjudicated beneficial owner of the 60 percent block) for the allegedly improvident surrender by the officer-directors of said right of purchase, accomplished by the July 28, 1969, agreement. The other is a direct claim stemming from the prerogative inherent in the 60 percent block and having as its basis chiefly the equivalent of a violative transfer of trust property to one having at least constructive knowledge. The freeing of the stock of this obligatory offer put the employee shareholder in a position to bargain for more than fair market value.[37]

For obvious reasons, Davis does not assert a lack of due process or of fair hearing or semblance thereof. He argues that the evidence, as a matter of law, does not support the finding (32) to the effect that from the standpoint of the employee shareholders the July agreement was made for an adequate consideration and without notice of the claims of Davis; and that, in reason, no other inferences could be drawn from the evidence than that the employee shareholders had knowledge of the constructive trust potential and that the sole or significantly major purpose of the July agreement was to protect themselves against and frustrate the recovery of Davis. However, the determination of these issues obviously is infected with the same judicial interregnum as pervaded the May matter. We note some counter reactive remarks. When the senior partner of Windham's firm, Montelone & McCrory, had indicated to the trial court his willingness to have it assigned to sit for all purposes on another case, despite Windham's then position that he had cause for a mistrial, it stated it was confused as to how it could act in such a schizophrenic manner. When Windham withdrew his motion for mistrial, the trial court stated: "I am glad your office got together . . . . [¶] You will see from . . . Smith's recordation of our conversation that even [he] didn't mention the employees not even this morning by his additions to the transcript. [¶] Isn't that right . . .? [¶] SMITH They weren't mentioned in the conversation your Honor, to the best of my recollection. [¶] THE COURT: You see?" Then, when it actually ruled, upholding the effectiveness of the July 28 agreement, it accompanied its ruling with the remark, "Because as long as we have two members of Monteleone and McCrory I don't dare antagonize them." If one of the stock rights issues is to be retried, the other should be too.[38] Under the circumstances we do not need to decide the question of law raised by Davis. However, we are of the view that the Davis position has considerable merit; so it is in no way unreasonable for the issue to be retried. Some treatment of the factors which support our viewpoint, for the benefit of the parties, is indicated.

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[37] There was some reference by both Chodos and Windham to a modification which, as to involuntary termination, changed the price for purchase by Custom or the owner of the 60 percent block from book to fair market value. Griffith spoke of about four modification agreements. Possibly reference was made to fair market value because this at least was what the employee shareholders could command. We are not sure if there were any such intervening agreements. If there were, it would have a tendency to emphasize the fraudulent aspect of these maneuvers. On remand it would seem reasonable for the trial court to explore the existence of any such intermediate revisions and any priority problem with respect to them. Market value generally is a much higher figure than book; Windham at one point asserted this to be the fact. A much more complex problem is encountered in establishing market, especially where transactions have been minimal. Another lawsuit would practically be guaranteed. The following citations might be of interest: *Norte & Company v. Huffines,* 288 F. Supp. 855; *Lassallette v. Parisian Baking Co.,* 110 Cal.App.2d 375; *Polinsky v. Vaughan,* 268 Cal.App.2d 183; *Piedmont Publishing Co. v. Rogers,* 193 Cal.App.2d 171; *S. C. Pohlman Co. v. Easterling,* 211 Cal.App.2d 466; 18 Am. Jur.2d, Corporations, §§ 219-221, pp. 747-750; 18 C.J.S., Corporations, § 403, p. 949; § 411, p. 991; Black's Law Dictionary deluxe (4th Ed.) p. 227 (book value) and p. 1123 (market value).

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[38] Code of Civil Procedure, section 631.8 motions may or may not be made again.

Of course no monetary consideration passed from the employee shareholders in return for the advantage they gained from the surrender of the options. The consideration argued for (chiefly by Berry, but it must be considered that the others stand with him, because they suggest no other) is that a Goodson-and-Hannam-dominated Custom obtained a more productive grade of service from the employee shareholders than it would have if they remained concerned over the likelihood of having to lose their jobs and sell their stock at book value if Davis got control of Custom. This could amount to a modicum but yet it would be gossamer because the employee shareholders still had to remain concerned whether Davis could get a judgment holding the surrender ineffective as against him. There was no evidence that the efficiency of the employee shareholders suffered because of their worry.

Of greater significance is the point that the very factors argued in support of consideration show that the employee shareholders had an awareness of Davis' claim of entitlement to a constructive trust on the 60 percent block and of the sinister implications of the corporate control he thereby would gain. There was considerable independent evidence of knowledge of Davis' claims. Berry stressed the "lawsuit in the works" and the chance of a shift in control to Davis whom he did not trust; and Miller testified that he was upset because Davis was "trying to bother him." The trial court stated that the time element made the thing "look fishy" and that it had a "strong suspicion that something not entirely above-board was afoot" but, in effect, it did not amount to substantial evidence. We do not necessarily concur in the latter evaluation of the trial court.

From the standpoint of Custom, the trial court would be comparing equities and certainly would be called upon to give heed to the dominant motive[39] of the employee shareholders—in light of the appreciation of Davis' goals, to protect themselves and frustrate him—and to the aspect of fraud against Custom as an entity. Berry was the only one who gave an indication of a preexisting desire to have Custom and Goodson and Hannam make concessions as to their purchase rights, saying that he had been making requests for removal of "strings" on his stock ownership; but his concern then apparently was over Custom "going public," which certainly was not a likelihood in July of 1969. There can be no question as to which of the motives we have looked at was dominant and which subordinate. It is also significant that it was only the right to purchase on termination that was fully eliminated in the July agreement.

With respect to the right ancillary to the 60 percent block, as noted, it was potentially, and ultimately became a part of the true "res" of the constructive trust.[40] The surrender of the right of purchase on the one hand and the corresponding gain of advantage on the other was the equivalent of a transfer of a trust interest.[41] The facts reviewed point toward a finding that the transferee was on notice that there was a claim of trust and that the relinquishment of the right was in betrayal of the trust obligation. Since, in fact, the constructive trust was imposed on the 60 percent block, under the circumstances, the transferees (the employee shareholders) would not gain a right of priority as against the constructive beneficiary of the trust (Davis). (Rest. 2d Trusts, § 288, p. 55; § 297, p. 74;[42] Civ. Code, § 2243; cf. Rest. 2d Trusts, § 286, and Comment b thereof, pp. 52-53.)

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[39] Compare the situation in the tax field where with respect to business deductions "dominant motivation" is the standard applied. (*United States v. Generes,* .... U.S. .... [31 L.Ed.2d 62]; see discussion in 58 A.B.A.J. 517 [May, 1972].)

[40] For all practical purposes Davis abandoned the res-pierced veil theory when the trial court limited the constructive trust to the 60 percent block and he pursued his claims for surcharge damages, contract interpretation and reformation, and royalty accounting.

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[41] In this regard the disposition (constructive transfer) of the (property) right, which was without notice to Davis, came close to being a violation of the preliminary injunction issued by Judge Kurland, the existence of which was actually known of by two of the employee shareholders and should have been by the others.

[42] Section 288: "Transferee with Notice. If the trustee in breach of trust transfers trust property to a person who takes with notice of the breach of trust, the transferee does not hold the property free of the trust, although he paid value for the transfer." (P. 55.)

Section 297: "What Constitutes Notice of Breach of Trust. A person has notice of a breach of trust if (a) he knows or should know of the breach of trust, . . .

"Comment:

"a. *What constitutes notice.* A third person has notice of a breach of trust . . . when he knows facts which under the circumstances would lead a reasonably intelligent and diligent person to inquire whether the trustee is a trustee and whether he is committing a breach of trust, and if such inquiry when pursued with reasonable intelligence and diligence would give him . . . reason to know that the trustee is committing a breach of trust.

". . .

"c. *When a transferee is chargeable with notice of a breach of trust.* A transferee of property is chargeable with notice of a breach of trust, if [knowing the nature of the trust] (3) he . . . should know that the trustee is improperly deviating from the terms of the trust.

". . .

In a sense the July agreement could be considered a fraud against the court itself. Implicit in the trial court's main ruling was its recognition of the Davis version that Goodson and Hannam represented to him, in effect, that one of the reasons they were going to put purchase rights on the minority stock (but which they omitted to do originally as to both Humphrey and May) was to have a preexisting setup which would facilitate reverter when the time and conditions were appropriate. The effect of the surrender was to frustrate one of the benefits of the judgment which the trial court might (and did) render and the trial court's desire to make Davis the beneficiary of its equitable powers. This could, as well, be considered a violation of the spirit, though not the letter of Code of Civil Procedure section 1908.

The employee shareholders stress that upon examination by his own attorney, each asserted that when he signed the July agreement he did not have any idea that Davis was seeking to impose a constructive trust on his own stock. This hardly rules out either an awareness of Davis' undertaking to gain a constructive trust on Goodson and Hannam's stock and control of Custom or a concern as to discharge from employment and subjection to the requirement of the original purchase agreement. Rather it seems a studious avoidance of the subjects.

There is no merit to the contention of the employee shareholders that laches should estop Davis from as-

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"j. *Notice of legal effect of terms of trust.* When a transferee . . . should know the terms of the trust, he is chargeable with notice of the legal effect of those terms. . . .

"k. *Notice of a deviation from terms of trust.* If the transferee has notice of [the nature of the trust] and if he had used due diligence would have ascertained that the transfer is in breach of trust, he takes subject to the trust. . . ." (PP. 74-78.)

serting noneffectiveness of the July agreement. That agreement was executed long after suit was filed, and Davis only learned about its existence in a court proceeding before Judge Kurland in September 1969.

4. *Remand for Trial:*

Considering all of the problems attendant to these two segments of the case, it is preferable that they be remanded for retrial. The task of retrying them on a severed basis, although admittedly troublesome, will not be insurmountable. The dismissal of the employee shareholders' cross-complaint which the trial court encouraged as a concommitant of its favorable ruling should be set aside.

CONTRACT INTERPRETATION-REFORMATION ISSUES

1. *Opposition on Derivative Basis:*

Davis' contract interpretation and reformation cause of action[63] was contingent. It was pressed against Custom because he did not get a constructive trust imposed on all of Custom's stock or assets. At this point, since it recognized that a Davis dominated Custom would concede his personal claims, the trial court, through the vehicle of intervention, put the minority shareholders into the position of making a defense for

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[63] The thought occurs that the interpretation-reformation issue might not be of much consequence if Davis' constructive ownership of 60 percent of Custom's stock holds up and he should exert the power he thereby would have to "recircle" the patent interest and the market potential back to himself and Hydra. However, regardless of what Davis might do in the future in that respect, the interpretation or reformation is an important item in support of the judgment to date, and would have a role in covering the situation while Davis, if he chose to do so, was processing what recycling he could achieve as a majority shareholder.

Custom on a derivative basis.[44] Goodson and Hannam were included as contingent[45] shareholders.

2. *Identification of Issues; Disposal of Uncomplicated Ones:*

The interpretation and reformation part of the judgment is epitomized in Conclusion 15. Without expressly saying so, some of the adjudication amounts to interpretation and some to reformation.

The first two items deal with the royalty percentage to be paid each quarter and with the time when the balance for the fiscal year is payable. As we understand it, defendants do not resist these adjudications.

The substance of the next two items therein, which is the subject of contest, pertains to the base on which royalties are computed. Serious problems are involved, and detailed discussion will follow.

The next item *affirms*[46] the contract language to the effect that "net profit" for royalty computation is "prior to deductions for . . . State franchise taxes," as against a possible defense-asserted modification established by conduct.[47]

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[44] The minority shareholders make the point that they did not have the opportunity to defend against the interpretation-reformation contentions because the trial court went ahead without them after granting their motions under Code of Civil Procedure, section 631.8. However, their court status with respect to the interpretations-reformation was not in their personal capacity, but as defenders in a derivative sense, which the court enabled them to do as interveners.

[45] The contingency, of course, being a successful appeal.

[46] Thus, it is neither a reformation nor interpretation, but merely a rejection of a defense claim of modification through conduct.

[47] The trial court did hold that Davis had waived the right to have erroneous franchise tax deductions eliminated from royalty computations prior to September 30, 1966. Davis does not challenge this ruling.

The next item deals with the imperviousness of Davis' royalty right to the narrowing of any patent or to the invalidation of any patent (unless of each and every) and the duration of Custom's obligation. Discussion on this court's interpretation will follow.

The ensuing item has to do with the preclusion of deductions which are not for ordinary, necessary, and reasonable expenses. No serious objection is interposed to this adjudication.

The final item calls, in effect, for the addition to the contract of a clause saying that in the event of any royalty default by Custom, the assigned patent rights shall revert to Davis. We find no substantial evidence in the record to support the proposition that this was to be included in the contract. The various references by Davis to representations on the part of Goodson and Hannam with respect to a purposeful default as a recapture device for Davis clearly related to actions dehors the contract which Goodson and Hannam could take on behalf of Davis. Davis testified that "[Goodson and Hannam] would do it [cause a reverter] by this default [process] which they didn't have to include [in the contract]."

3. *Some Defense Points*

Before considering the reversed issues, we cover some defense points of opposition[**] to this phase of the case. Most have been rendered moot by the rulings made and to be made which for all practical purposes render only interpretive relief to Davis with respect to the patent assignment contract. However, a few deserve brief consideration:

[**] Such as lack of substantial evidence; inherent improbability of Davis' version because of threat to concepts of bona fide sale and common control; necessity of false representation. As to the latter, we feel that, considering the attorney-client relationship and the high professional duty attendant to it, Goodson and Hannam's presentation of the documents to Davis without disclosure of their variations from the anterior understanding (inferable from Davis' testimony) and with his unquestioning acceptance of the Hydra fragmentation as a demonstration to them of his trust, was sufficient.

(1) Contention that there is no finding that there was any mutual contractual intent between Davis and Custom antedating the written contract. There is none specifically, but the following exists by implication: Goodson and Hannam had to be acting for and so were the "mind" of both Davis and Custom, in formulating the intent for each. What they said in their representations, in effect, amounted to the mutual intent which was supposed to find expression in the written contract.

(2) Contention that there was no evidence that Davis did not know what was in the written contracts or that he acted reasonably in not reading them. Our analysis: Davis' testimony that he did not check the contract as to certain aspects allowed the inference that he did not check it at all. As to Davis' reasonableness in not reading the contract, it is implicit in the "reliance" finding that Davis had complete trust and faith in Goodson and Hannam and had put his renegotiation and tax problem fully into their hands. There is ample support in the record for this. For example, Davis testified that he was accustomed to following the advice of his attorneys without question; that he always used counsel, did not "second-guess important matters," that he "left it [the Custom Plan] up to them [Goodson and Hannam]." The trial court was justified in determining that Davis did have implicit reliance in Goodson and Hannam and was not unreasonable in failing to check the contract against the oral representations.

(3) Contention that Davis was guilty of laches in pressing his claim for contract interpretation and reformation. This seems inapplicable to the court action that we have sustained. In any event, the same factors of trust set out above plus the evidence that Davis thought everything was perfect until late 1965 (discussed in another segment of the opinion) meets the objection.

(4) Contention that the minority shareholders relied on the contract, and it would be unfair to them to reform it or give it a liberal interpretation. Discussion: We found nothing in the record to indicate that the employee shareholders became familiar with the wording of the contract. There is no particular reason why the employee shareholders should have. Berry testified that although Davis told him of Custom being independent and a recipient of a one-half patent interest from (Davis), "he never discussed anything about the contract with [him]." The others did not allude to the contract. Although May perhaps had some knowledge of the contract, he gave no indication that he relied on any aspect as to which relief to Davis is being sustained by us.

(5) Contention that Davis is not entitled to equitable relief by way of contract interpretation and reformation because he, according to Interveners, secured his switch patent under false pretenses (unclean hands). We discuss this subject more fully later. Suffice it now to say that Interveners do not have a close enough connection or strong enough interest or show sufficient likelihood of damage to warrant the court expending the judicial time it would take to make a determination as to the validity of Interveners' claim. A complaining party has to be injured. (*Germo Mfg. Co. v. Mc-*

Clelland, 107 Cal.App. 532, 541.) Also it would seem that this defense would not be available under the *Clark v. Millsap, supra,* 197 Cal. 765 philosophy. Moreover, the switch patent is just one of three. It was fortuity that it turned out to be the one which is sustaining Custom's activities.

4. *The Royalty Base*

On this subject we have concluded: (1) That the circumstances do not permit a reformation of the patent assignment contract to make it provide that Custom shall pay royalties on 100 percent of what it processes. (2) That there is no evidence to support a reformation making the related-to-invention (instead of the embodying-the-invention) concept applicable to the gross measure for royalties. (3) That, adhering to the present contract provision for payment of 65 percent of net profits from activities related to the inventions, there is no evidence to support a reformation providing that Custom never will engage in activities except those related to the inventions unless Davis consents. Our analysis follows.

Paragraph 5(c) of the judgment (¶ 15(c) of the conclusions) provides, in effect, that the royalty base clause in the patent assignment contract (part of paragraph 5 thereof) should be reformed. The adjudication rests on the premise that the contract clause was not in accord with the anterior understanding between Davis and Custom. We have previously considered how any representations of Goodson and Hannam to Davis would be evidence thereof.

The contract clause, as we read it, provides that the royalty base shall be 30 percent of the gross selling price of all products (1) manufactured under any of the processes covered by the patent applications or (2) embodying any of the inventions covered by the patent applications,"[49] but that payments shall not exceed 65 percent of net profits defined as those from activities related to the invention. It goes on to provide that if Custom "has profits or losses from activities not related to the invention, then the net profits from . . . activities relating to the invention shall be separately computed as if [it] were the sole activity. . . ." The contract contains no restriction on Custom processing unrelated items. This wording shows no recognition of a concept of restriction subject to an exception of permission by Davis and the possibility of such only on condition that royalties be paid on the allowed unrelated items.

The judgment clause reads: "(c.) In computing its . . . net profits,[50] Custom shall include all of its . . . net profits . . . from all of its . . . . activities."[51] This appears to set a broad "net" royalty base—everything sold whether related to the inventions or not. However, in light of wording in judgment clause 5(d), of language in finding 26 (d) upon which those two judgment clauses rest, and of the trial position taken by Davis, 5(c) must be construed differently (with some straining) or modified in its language.

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[49] We have broken up a single compound phrase into two. See reference infra to these elements earmarked in fn. 59.

[50] The clause deals with gross sales as well. For simplicity's sake we handle the problem with the base which the parties used. The apparent measuring inconsistency discussed elsewhere is not significant here.

[51] The language of the clause is "manufacturing and selling activities." The descriptive words are understood in our discussion.

Paragraph 5(f) dealing with duration of the royalty obligation, twice makes reference to "Custom's obligation to make payments . . . based on 100% of its . . . net profits." This repetition, we feel, does not serve to fortify 5(c) against the weakening factors we discuss shortly.

Judgment clause 5(d) says, "Custom shall not engage in any . . . activities unrelated to the inventions . . . , or *otherwise* not subject to payment . . . except with Davis' consent." (Emphasis added.) "*Otherwise* not subject to payment"[52] suggests that "activities unrelated to the invention" *also* are not subject to payment.

Finding 26(d) reads:

"26 . . . . Goodson and Hannam [represented that];

". . .

"(d) The payment formula would provide for the payments . . . to be . . . computed on the basis of . . . activities related to any of the inventions . . .; Custom would never engage in any . . . activities . . . except those related to . . . the inventions . . . (except with Davis' prior consent); . . ."[53]

In the second cause of action of the third amended complaint, Davis alleges that "[h]ad the . . . arrangement [in December] conformed to the representations made by . . . Goodson and Hannam, [it] would have included . . . the following . . .: . . . Custom would not engage in any . . . activities unrelated to the inventions. . . . Further, . . . Custom would be obligated to make payments . . . based on . . . the . . . net profits . . . from . . . all products [processed] by [it]; including . . . products embodying or related to the inventions . . . , all component parts of such products, . . . and all products [processed] with . . . techniques . . . or equipment developed by . . . Davis."

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[52] It is not clear what circumstances other than unrelated-to-the-invention would make a given item not subject to payment.

[53] There follows this phrase: "[*A*]*ccordingly,* Davis would always be entitled to receive payments based on 100% of Custom's net profits . . . ." (Emphasis added.) Clearly this is simply an observation (and inaccurate at that—because Davis might give a consent not conditional upon Custom paying royalties) of what would follow from a contract which read in accord with the finding.

In oral argument to the trial court, Chodos stated: "[W]e will stipulate that [Custom does not] have to pay on hula hoops and mattresses and garments that they manufacture. What we are claiming is [it has] to pay on all their belleville spring and sensing device actuated switches, which is 100% of [its] production." The following day Chodos summed up his contentions: "[Custom should pay royalties] . . . on all sensing . . ., actuating . . ., or combined sensing and actuating devices[;] . . . all products heretofore sold or manufactured by Custom fall within that category, and . . . no products are to be made in the future by Custom which fall outside that category without . . . Davis' express consent."

At another time he asserted that it was established by Davis' testimony and to be inferred from Custom's conduct (payment of royalties on entire production for about 8 years) that the oral understanding had been that "Custom would never go into the business of selling products outside of the agreement without Davis' prior consent."

On June 23, 1970, the trial court filed a memorandum entitled "INTENDED RULINGS RE INTER-

PRETATION AND REFORMATION OF AGREEMENTS." Part of it referred to the matter of the base for royalty payments. The format was to quote a point urged by Davis and to give a "tentative ruling." Thus, although each concept initially was that of Davis, any that were granted became that of the trial court. The pertinent one is, "Plaintiff's Point 1: 'The agreements should be construed to mean that Custom's obligation . . . extends to profits earned from all of its products . . .; *conversely*, that no products are to be [processed] which are not subject to payment . . ., except with the consent of Davis.'

"Tentative ruling: GRANTED." (Emphasis added.)

An accepted meaning of the adjective "converse," of which "conversely" is the adverb, is "reversed in order or relation" (Webster's Third New International Dict., p. 498). By the use of the adverb Chodos has the trial court saying, as it was put in the finding, that no products are to be processed which are not subject to payment (because related to the inventions) and so Custom's obligation extends to profits from all its products.

Thus, it appears that Davis, from pleading through proposed findings, was thoroughly committed to the concept that royalties were to be payable on profits from activities related to the inventions and that Custom was not to produce any others without Davis' consent.[54]

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[54] Compare situations where theory on mixed questions of law and fact cannot be changed on appeal (*Estate of Wester-*

(This footnote is continued on next page)

It was not until the proposed conclusion was composed that the 100 percent royalty base was set out as the dominant proposition[55] with a restriction on production of any other item (5(d)) being, as Chodos puts it in his brief, "largely ancillary." Probative findings control the conclusions which go into the judgment. (4 Witkin, California Procedure, Trial, § 346, pp. 3147-3148, citing *People v. Reed,* 81 Cal. 70, 76; *Robinson v. Raquet,* 1 Cal.App.2d 533, 541, and *Hunter v. Sparling,* 87 Cal.App.2d 711, 721.)

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man, 68 Cal.2d 267, 279; *Carmichael v. Reitz,* 17 Cal.App.3d 958, 969; *Goodwin v. Wolpe,* 240 Cal.App.2d 874, 878-879) and where findings must adhere to the issues as put in the pleadings and trial. (*Crescent Lumber Co. v. Larson,* 166 Cal. 168, 171, and *Barnhart v. Blackburn,* 137 Cal.App. 240, 242; see also: *Trafton v. Youngblood, supra,* 69 Cal.2d 17, 30-32.)

[55] If there had been a basis for holding that the contract should have provided that royalties be paid on 100 percent of processing, and also that no items unrelated to inventions be produced, it might be considered that an attempt was being made to set a form of liquidated damages for violation of the production restriction. It is doubtful that such a damage provision could have prevailed. It would not have been a true measure of damages. This is so because as many related items as nonrelated items might not have been marketable. Moreover, Custom might have produced patent related items with a lower expense ratio, so that its net might have been higher. It would have been necessary for the trial court to have taken evidence on what would have been the most patent related items that Custom could have marketed and on whether, if it had not branched out into nonrelated items, it could have produced the related items at a lesser cost. Damages apparently would have been for royalties on whatever additional patent-related items could have been produced at a net calculated on the constricted operations, plus any increase in royalties on the actual patent-related production based on the difference between the actual net and the hypothetical net.

Also of interest is testimony of Goodson and Hannam which indicates that it was their feeling that if Davis got royalties on nonrelated items and the combined royalties exceeded 100 percent of Custom's profits from its production related to the invention, this circumstance would frustrate the goal of the Custom Plan; but they had nothing to base this opinion on.

Thus, the 100 percent royalty base is out, and for purposes of the balance of this discussion we assume a judgment clause consistent with finding 26(d).[56]

There are two areas wherein the trial court found that the anterior "mutual intent" (as allegedly shown by purported Goodson and Hannam representations) called for a change in the structure of the patent assignment contract. One change would be the application of the related-to-invention concept to the gross measure. The trial court finding speaks of calculating payments not on "the . . . sale of devices . . . embodying the inventions . . ., but . . . rather . . . on the basis of . . . activities related to . . . the inventions . . ." The other change would be the addition of the provisions that Custom would never engage in activities except those related to the inventions, as against the intimation of the contract that there might be production of unrelated items as of right, as to all of which no royalties would be payable.

We found no evidence to the effect that Goodson and Hannam represented to Davis that the gross measure would be on sales of items related to the inventions. Thus, to the extent that finding 26(d) suggests that the gross formula should so provide, it is not supported. Further, we found no evidence that Goodson and Hannam represented to Davis that Custom would never engage in activities except those related to one or more of the inventions except with Davis' prior consent. Rather, there are a few expressions from Davis suggesting that he anticipated there would be some unrelated activities.[57] Davis argues that the payment record shows a contract construction for the restriction-permission postulate (rather than a failure to meet an anterior understanding). However, there is no equivocal language to a construction of which this conduct would apply. Amendment by conduct is not argued, and just the payment record would be a too fragmentary support. In any event, the only court finding is based on a differing anterior understanding. This finding, as our discussion indicates, is not supported by the evidence.

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[56] Perhaps if judgment clause 5(c) had not been weakened by judgment clause 5(d) and Davis had not committed himself to the concept of finding 26(d), and there was no evidence to support finding 26(d) and some to support judgment clause 5(c) (and there was a modicum, such as Davis' testimony that Goodson and Hannam said that "the objective . . . was to get all they could in Custom . . . that would come back [to him] as a capital gains dollar. . . ." that Goodson and Hannam's explanations to him made him think originally that all of Custom's profits were to be paid to him, that he was led to believe that Goodson and Hannam were going to run Custom for "value received," that the idea always was of optimizing the returns for him; and the record of payments on 100 percent of production for about 8 years), we could direct the inclusion of a replacement finding and uphold judgment clause 5(c). However the posed negation is evanescent.

As a practical matter, Custom's activities under the patent assignment contract as it exists in these respects, will be regulated by Davis under the power of his control through stock ownership;[58] and also the contract must be considered as subject to a covenant of good faith which would require the processing of sufficient products related to the inventions to keep Hydra out of renegotiation problems and bring Davis reasonable amounts of capital gain income. (***Redke v. Silvertrust**, supra*, 6 Cal.3d 94, 100; ***Brewer v. Simpson***, 53 Cal.2d 567, 588-589; 1 Witkin, Summary of Calif. Law, Contracts, § 242, pp. 271-272.)

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[57] Davis said in "one of his [Cook] affidavits" that "to plan . . . for the probability that other products might be evolved, . . . the business operation was split up into several corporations. . . ." (Probably meaning both the Hydra fragmentation and the Custom assignments.) He testified that a start had been made on production for commercial uses as against military and when Custom came along, basically it took these over. He indicated that he was aware that Custom was engaging in independent research.

[58] For that matter Davis might soon institute action leading toward an abandonment of the Custom Plan and a winding up of Custom subject to the rights of the minority shareholders. We offer no intimation as to what the extent of these would be.

It must be recognized that not having a reformation calling for royalties on 100 percent of production or restricting production absent consent, causes some problems to remain upon which it is not appropriate for us to pass since the trial court never really met them. We simply highlight ones we see; there may be others.

1. Whether there is, in the contract wording, a difference between the royalty bases for gross and net (the net clause might be construed as saying, "*so* related," referring back to the two descriptive elements of the gross measure),[59] and, if so, whether such difference should remain. Goodson and Hannam testified that they did not recall if a difference was intended.

2. What is the effect of the use of the term "inventions covered by the applications" (Goodson and

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[59] See footnote 49, *supra*.

Westbrook's trial contention (for Goodson and Hannam) as to the proper construction of the contract was that essentially Custom's obligation was to pay royalties only on the processing of products which were strictly within the scope of (not just related to) the patent, and that the "related-to" language meant spare parts and test reports and possibly products not technically infringing but so close in form and function as to be clearly derived from the patent. He gave the rather weak excuse, to explain away the past conduct argument of Chodos, that a gradual change in production kept Custom from realizing that some of its products had not called for royalty payments.

Hannam did not seem to know why it had been used); and, possibly, whether any claims in Davis' applications were not included in the patent award. (If so, under *Zenith Corp. v. Hazeltine* (discussed, *infra*) 395 U.S. 100, and the sound part of *Automatic Radio Co. v. Hazeltine* (discussed, *infra*) 339 U.S. 827, there should be no legality problem.)

3. Possibly, what the term, "related to the inventions," means, and what the nature of Custom's products is and has been since September 30, 1966.[60] It might be noted that Goodson and Hannam said that they had not discussed with Davis who would make such determinations; that Davis might bring the issue up under his audit rights.

5. *Duration of Royalty Obligation:*

With respect to the duration-of-royalty-obligation problem, we note the following clause in the contract: "6. The payments on said purchase price shall be paid for so long as the patents . . . and . . . improvement patents shall be in existence and shall terminate on the expiration of such patents and improvement patents."

Finding 26(c) reads in part as follows: "[T]o induce Davis to enter into such agreements, Goodson and Hannam [represented that] . . . even if one or more of the patents[61] should expire, or . . . be declared invalid or limited in scope, such events would not affect Custom's obligation to make the . . . payments

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[60] It would be considered, no doubt, that Custom had waived any adjustment prior to this, if one were due, as was considered for Davis with respect to franchise tax deductions.

[61] Thus, evidently referring to each of the three patents, one of which was dealt with in each agreement, showing the integration of the three agreements into a single whole.

. . . , so long as any of the claims[62] of any of the . . . patents or . . . improvement patents . . . remained in effect. . . ."

Judgment clause 5(f)[63] reads in part as follows: "Custom's obligation to make payments to Davis . . .[64] shall not be affected by any decree[65] limiting the scope of . . . or declaring invalid any patent . . .; but Custom's obligation . . . shall continue so long as any claim of any patent or improvement patent . . . is in effect."

It will be noted that the finding and conclusion do not provide for an interminable obligation as defendants seem to conceive when arguing that only the sale of a full patent interest will support such. We have found no testimony in the record, even from Davis, establishing that Goodson and Hannam specifically made a representation to Davis as set out in finding 26(c). However, there was testimony that Goodson and Hannam represented that the Custom Plan was being tied into "ongoing patents which would make [the] program run into the future . . ."; and that they "had drawn the contract . . . in such a way that the patent improvements would . . . provide that [the Custom Plan] would continue for some considerable time more than the first patent. . . ."[66] Davis also testified that he was led by Goodson and Hannam to understand that "the objective of the [Custom] plan" was to have "all they could . . . come back [to him] as a capital gains dollar"; to "[optimize] the return" to him; that they were getting him the most returns that the government would allow without hurting the Custom plan, "all that was possible." Anyway, we see this feature of the judgment as an interpretation rather than a reformation, and actual representations are not essential. The finding need not have been so expressed.

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[62] Used in the patent law sense wherein a single patent will likely embrace several claims often reduced from the number of claims specified in the application as being the invention.

[63] Paragraph 15(f) of the conclusions corresponds.

[64] The omission is a reference to the base of "100 percent of . . . gross sales . . . or net profits." Under our ruling with respect to the royalty base, these references will no longer be appropriate.

[65] In light of the trial court's ruling on the cross-complaint, what is in contemplation obviously is a decree obtained by a third party.

The tenor of the representations and the clear implications that the three contracts were, in fact, a single whole,[67] taken together as the surrounding circumstances (Civ. Code, § 1647; Code Civ. Proc., § 1860; *Pacific Gas & Elec. Co. v. G. W. Thomas Drayage, etc. Co.* 69 Cal.2d 33, 42-43; *Lee v. Springer Laundries, Inc.*, 8 Cal.App.3d 1003, 1006), support the proposition that the language of the contract does not mean that there was a separate royalty obligation for each patent, or that all the patents had to remain in existence[68] for the royalty obligation to remain extant, or that any patent had to retain its full scope. The language of the final phrase, read in light of the mentioned circumstances, to the effect that the royalty obligation would not terminate until "the expiration of such patents and improvement patents" makes room for the trial court's interpretation that the obligation "shall continue so long as any claim of any patent or improvement patent . . . is in effect."

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[66] There was testimony that Custom had obtained an improvement patent after 1957, and attorney observations suggested that there were others, perhaps obtained by Davis. In any event, under the contract, improvement patents were to be mutually enjoyed.

[67] There was, of course, a clear basis for the trial court considering that there was but a single program, despite the formation of three separate companies and the composition of three separate contracts, on the theory that that arrangement simply was a device for tax advantages along the lines of the fragmentation of Hydra into seven units.

[68] Defendants appear to be stressing the difference between all patents having to be simultaneously in effect for the royalty obligation to persist as against the concept of only one, no matter how narrowed, having to be effective even though it is not one to which Custom production currently related. We see no

Defendants urge that a broad royalty base would be illegal and cannot be sanctioned. Presumably they would urge the same as to what the discussed duration-of-royalties-interpretation would bring about.

We do not conceive that an agreement to pay royalties in return for the assignment of a one-half interest in a group of patents at an unfluctuating percent, even though the assignee may process products under only one or even as long as only one patent or improvement patent is extant, though narrowed in scope, is illegal under *Zenith Corp. v. Hazeltine*, 395 U.S. 100. In fact, *Zenith*, as we see it, would support the broad royalty base concept in our case if the evidence had shown that it had been agreed upon. In *Zenith* it is made clear that there is no ban against the assignor and assignee serving their mutual convenience by basing royalties on the sale of all of the assignee's products irrespective of its use of the patents. The *Zenith* injunction did not prevent this. It pertained only to the situation wherein the patent monopoly is used as a lev-

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reason why the trial court could not adopt the position that the understanding in December 1957 was that one patent was enough to sustain royalty payments. For one thing, there is no question but what Goodson and Hannam had the viewpoint that one patent was sufficient to support the execution and implementation of all three contracts. Incidentally, this is further demonstration that they were considered one integrated deal.

erage to extract a broad royalty condition from an unwilling negotiator so that the result is collection of royalties not for the potential use of the invention but for selling articles not within the reach of the patent. The patent owner does have the privilege to exact royalties as high as he can negotiate with a freely acting prospective assignee. In *Automatic Radio Co. v. Hazeltine,* 339 U.S. 827 (overruled by *Lear, Inc. v. Adkins,* 395 U.S. 653, on the estoppel ground only) the provision for a broad royalty base was proper because the parties simply chose, mutually, a convenient method of fixing the business value of the privileges granted. Clearly, if Goodson and Hannam had been acting forthrightly, considering the ostensible object of the Custom plan and Goodson and Hannam's position as the "mind" of each party, Custom was not resisting the formulation of an agreement which would call for it to make royalty payments in accord with the indicated interpretation as a convenient way to measure the value of the patent interests assigned to it; and Davis was not using a monopoly leverage to force Custom into an agreement it was reluctant to make. All this seem particularly sound in light of the various provisions of start-up help which, themselves, though not so specifically designated, could be viewed as consideration for Custom's commitment to pay royalties on the basis indicated. (See: Alderman, *An Antitrust Decision: Lear v. Adkins* (Jan. 1972), 58 A.B.A.J. 45, 46-47.)

SURCHARGE DAMAGES

1. *Theories of Recovery by Davis:*[69]

There is no problem of legal support for damage items as to which a theory for direct recovery is applicable such as that part of some awards represent what would have been royalty, that dividends and cash redemptions are a fruit of the "res" of the constructive trust (the 60 percent block), or that manipulation of the salary payments or of the Denes expenditures were a breach of a professional promise. However, there is a question about a pro rata personal allocation of strictly derivative recoveries. We feel that the judicial action was logical and is supported by a line of respectable authority. Generally, the policy is to prevent unjust enrichment and avoid multiplicity and circuity of action.[70] (*Perlman v. Feldmann* (2d Cir. 1955) 219 F.2d 173, 178; *Norte & Co. v. Huffines, supra* (S.D.N.Y. 1968) 288 F.Supp. 855. 865 [follows general rule of not by-passing the corporation, but lists various exceptions, among them protection against dissipation of corporate recovery by management, citing

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[69] It would seem that Davis might have sought but did not seek a retention of jurisdiction by the trial court to give him indemnity recovery against Goodson and Hannam to the degree he might be unsuccessful when and if, as the majority shareholder of Custom, he ultimately took steps to secure a reassignment of the patent interest and acquire the Custom enterprise by having Custom purchase the stock of the employee shareholders and by himself, through negotiation, purchasing the stock of May, a step the decision in *Redke* appears to approve. The indemnity concept might also apply to any losses and expenses suffered by Davis in a battle with the minority shareholders over other rights or obligations not asserted as a theory in the suit or pressed in this appeal.

[70] This is what the trial court had in mind. At one point, it referred to "the corporate derivative claim [of Davis]" and stated, "Now, what we have done by this order . . . is shortcut that circuitous route."

Backus v Finkelstein, 23 F.2d 357]; *Amen v. Black*, 234 F.2d 12, 23; *Geltman v. Levy*, 207 N.Y.S.2d 366, 369, citing *Weinert v. Kinkel* (C.A.N.Y. 1947) 71 N.E.2d 445, 446; *Joyce v. Congdon* (Wash. 1921) 195 Pac. 29, 30; *Brown v. DeYoung* (Ill. 1897) 47 N.E. 863, 866; *DiTomasso v. Loverno*, 293 N.Y.S. 912, 918; *Eshleman v. Keenan* (Chancery Ct. Del. 1937) 194 Atl. 40; *Keenan v. Eshleman* (Del. 1958) 2 Atl.2d 904; *Johnson v. American General Insurance Co.* (D.C. 1969) 296 F.Supp. 802, 809-810, citing *Bellevue Gardens, Inc. v. Hill* (D.C. 1961) 297 F.2d 185; *Young v. Columbia Oil Co.* (W. Va. 1931) 158 S.E. 678; 69 Harv. L.Rev. 1314 [Note, Individual Pro Rata Recovery in Stockholders' Suits]; cf. *Sutter v. Gen'l. Petr. Corp.*, 28 Cal.2d 525 [shareholders considered to have a nonderivative claim]; *S.E.C. v. Manor Nursing Centers, Inc., supra.*) We discuss in detail only those awards which we feel were fairly controversial or in error.

2. *Attorneys' Fees For the Personal Defenses of Goodson and Hannam, May, and the Employee Shareholders:*

We have concluded that these were properly included in the surcharge damages awarded against Goodson and Hannam. There was no statutory pretext for the employee shareholders. We do not consider that Goodson and Hannam or May qualified under Corporations Code section 830(f). The chief claim against Goodson and Hannam was for breach of professional duty. This was involved as well in the Denes investments and the May consulting fees. The pursuit of a constructive trust on the May stock was on the theory of joint enterprise with Goodson and Hannam.

3. *May's Consulting Fees:*

The evidence was conflicting on this subject. May's experience and record in the sales field was brought out together with his assertions that he considered himself as available for consultation and capable of rendering some assistance and that "when . . . something came up in selling that they thought [he] could be of assistance to [he] was called." However, upon examination by Chodos, May conceded that it was he who had proposed that he get a salary, that "[he did not] have any particular duties," and that he did not give Custom's management any indication of how much time he would spend.[71] May testified that the decision for him to get consulting fees was in 1966, which could have been after the Keatinge demand telephone call, and that he started getting the fees in January 1967 which, of course, was after the suit was filed. We cannot say that the trial court had no basis for finding that the consulting arrangement really was not genuine[72] and was not worth to Custom anywhere near the sums paid over to May.

4. *Attorneys' Fees For Custom and Interveners:*

The situation, we feel, should be viewed from this standpoint: Initially, the contingent owner and then in midsuit the constructive owner of the 60 percent block, Davis, in his independent and separate capacity as the patent assignor, was suing Custom to have the patent assignment contract interpreted and reformed and also to collect royalties based on contract meanings as contended for.[73] In face of this, existing management, whose power was being sought by Davis, on its own, put up the first resistance. Then, when the powers passed under court control favorable to Davis, the minority shareholders (and Goodson and Hannam under the contingency of reinstatement), on a clearly derivative basis (court sanctioned through the allowance of intervention), resisted the contentions of Davis. Ideally, there should have been court control of the matter of counsel fees from the outset. The typical derivative situation should have prevailed whereby disputing shareholders finance their own resistance[74] when the corporation fails to act and at the close of the litigation, on the premise that they have protected rights of the corporation, apply to the court for reimbursement of reasonable fees from corporate funds. (*Fletcher v. A. J. Industries,* 266 Cal.App.2d 313, 322-325; *Mann v. Superior Court,* 53 Cal.App.2d 272, 280-281; 1 Ballantine & Sterling, California Corporation Laws, (4th Ed.) Directors; Management, § 89, p. 162.) At that point the court has considerable discretion. Where it feels that unsuccessful opposition was unwarranted, it can disallow the request *in toto.* Where the derivative resistance is successful in whole or in part usually an appropriate allowance is made.

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[71] At one point, when Beardsley pointed to May's record and availability for consultation, he further stated that, if the trial court need it, he could put on some testimony about conferences with salesmen; but this was never done.

[72] On June 3, 1970, the trial court made an observation to the effect that from May's evidence there was nothing to show that he had anything more to do with Custom except to be its angel.

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[73] We do not include Davis' quest for a constructive trust on all the assets of Custom. Opposition to this essentially was the role of Goodson and Hannam and the minority shareholders, because the Davis theory was that these were personal assets to be reached through the piercing of the corporate veil. It was really for them, not for Custom, to assert the corporation's integrity and then to defend against the imposition of a constructive trust on the stock they owned. For a time, the claim for rescission had to be considered, but it was abandoned in amended pleadings.

[74] Fundamentally, this is the position in which the trial court put the interveners.

Interveners cite *Olson v. Basin Oil Co.,* 136 Cal. App.2d 543. This was a case where a minority shareholder was attempting to have the court preclude the corporation from having counsel, which the majority shareholders (through the board of directors) wanted it to have.[75] Nonetheless, the policy factors seem applicable to the situation where the minority shareholder wishes the corporation to have counsel.

In the instant matter, the trial court, we feel, had the right to render a judgment against Goodson and Hannam as the ones primarily responsible for causing Custom to pay fees out to its attorneys. This could be for any amount of the fees which did not represent legitimate service to Custom in the area of contest involving it and also for any amount it felt was not warranted for services within that area. It must be assumed that the trial court concluded that no fees were warranted for the derivative defense in light of the fact that its judgment favored Davis all the way.

We are reversing this in part. This means that the question of fees for the attorneys who represented Custom initially and for those who represented the interveners should be reexamined. Clearly but a small amount of the very substantial fees paid to Mitchel, Silverburg & Knupp can be considered as allocable to the limited items of damage which we hold are subject to our reversal. But some of their preparation may have related thereto. This the trial court should consider. To the extent of the proper percentage of its ultimate allowance, the judgment against Goodson and Hannam related to the fees to Mitchel, Silverburg & Knupp shall be reduced.

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[75] This is true also of *Suburban Water Systems v. Superior Court,* 264 Cal.App.2d 956, 959-961, where the plaintiff, although a substantial shareholder, was a minority one.

Further, by implication at least, interveners have applied for an allowance out of corporate assets for fees paid to their attorneys. The trial court should inquire into what proportion of their trial and appellate services fairly relates to the specified subjects and then should make an appropriate allowance and direction for payment.

Derivative moves of this type by the minority shareholders were an exigency to which Davis must be said to have submitted in allowing Custom to be organized and operated as part of the Custom plan.

5. *Reduction For Corporate Income Tax:*

Goodson and Hannam argue that the trial court should have taken into consideration that as to those parts of the surcharge damages which represent 60.67 percent of 35 percent of the damage item (representative of a supposed dividend or of an increase in equity position in Custom) there should be a reduction equivalent to 60.67 percent of what would have had to have gone out in corporate income taxes if the funds had never been disbursed by Custom and claimed as income tax deductions. The concept is that Davis should not recover more than he would have gotten if that had been the situation. One of the factors to consider is the possibility that Custom might be subjected to tax liability on an assumed intermediate recovery of the judgment amount going direct to Davis which would be taxable and that Custom would have to seek recovery from Goodson and Hannam, the parties who caused it to make the improvident disbursements. We think that this would apply only when Davis made an actual recovery from Goodson and Hannam. Rather than reduce Davis' recovery by the estimated income tax figure and put Custom to the trouble of attempting recovery, if required, it seems more within the parameters of equity, more judicially efficient, and sufficiently practical to have the judgment declare that Davis hold as a constructive trustee for Custom (particularly with Davis in control) the necessary portion of any actual cash recovery from Goodson and Hannam to be applied to any Custom income tax liability which might eventuate.[76] It would seem more equitable for Davis rather than Goodson and Hannam to benefit from any decision of the taxing authorities not to make the claim.

6. *Managerial Salary Offset:*

Finally, there is one of the items which the trial court characterized as offsets to the surcharge judgment. Again court and counsel seem to have adopted a term for convenience.[77] This is the $98,500 set by the trial court as reasonable for managerial salaries for Goodson and Hannam.[78] A small quantity of evidence from Riskin, DeCastro and Goodson and Hannam was put on as to some of the nonlegal services rendered by Goodson and Hannam. However, no testimony or other evidence was presented on the reasonable value of the services or on any standard therefor in the corporate executive field.[79] The situation was different with respect to the value of Goodson and Hannam's legal services to Davis where both Page and Hochman testified.[80] The trial court could have gotten by without value testimony as to the legal services, since the law recognizes that the trial court itself has a degree of experience (which could be small or great) sufficient to allow it to pass on the issue. (*Elconin v. Yalen*, 208 Cal. 546, 549-550; *Excelsior Etc. School Dist. v. Lautrup*, 269 Cal.App.2d 434, 448; *Independent Iron Works, Inc. v. County of Tulare*, 207 Cal.App.2d 164, 167.) However, we know of no such rule in the corporate salary category. The same reason does not exist. Under the circumstances this particular part of the judgment (86.23 percent of $98,500 for a so-called offset) must be reversed and a remand made for the purpose of allowing the court to receive evidence on value and standards. In that connection, our viewpoint is that the burden of proof is on Davis to establish that the amount taken was not fair.

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[76] We appreciate that Custom might be said to have made an incorrect deduction for income tax purposes as to the full amount of any improper disbursement caused by Goodson and Hannam. However, it seems likely that another basis for deduction might be present even though Davis' derivative type claim did not seek full recovery for Custom.

[77] As we see it, the characterization is only apropos the $100,000 attorneys' fee figure. As to the managerial salaries, rather than a determination that Goodson and Hannam are liable for the full amount of salaries they caused Custom to pay to themselves to be offset by an amount determined to be what was reasonable for Custom to pay them, the determination should be that Goodson and Hannam's liability is for the excess they caused Custom to pay to themselves above what the trial court determined was reasonable. The distinction is fine (the end result being the same), but it does seem to be there and deserving of illumination, at least in a footnote.

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[78] 86.23 percent of this figure was used, in compatibility with the award.

[79] The trial court did not even seem to rely on the figures set by Judge Kurland which may or may not have been based on evidence or stipulation equivalent to evidence of value or standards.

[80] Hochman gave examples of both a flat and a contingent fee. The trial court obviously considered the former the appropriate vehicle. It adopted Hochman's lower range of $100,000.

7. *Disbursements to Denes*

The recovery stemming from the purchase of stock in and the loan of funds to Denes Co. is supportable on two theories. One is that of an action of a derivative nature[81] through Davis in his midtrial category of constructive shareholder, premised on the violation of an officer-director's duty to the corporation (*Schwab v. Schwab-Wilson Machine Corp.,* 13 Cal.App.2d 1, 3); the other is that of an action of a direct nature premised on the violation of an attorney's duty to his client.

The derivative claim was actionable because Goodson and Hannam's employment of their control and influence was not fully an "exercise [of] their powers in good faith," in the face of conflicting interests. (Corp. Code, § 820. See also 1 Ballantyne & Sterling, California Corporation Laws (4th ed.) Directors; Management § 78.01, pp. 139-141.) Such an officer-director cannot make a deal unfair to the corporation while using the influence and power of his position for his own interests. He is accountable for any disregard of his duty. (*Ibid.*, p. 142.)

At the time that Goodson and Hannam started putting Custom into the Denes venture they were subject to a conflict of interest. Goodson and Hannam (and May) had previously invested some of their own funds in

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[81] The usual requirement of establishing a referral to the board of directors and the reason for its failure to act may be omitted where it is obvious that there was an antagonistic board of directors. Also, the courts recognize as an alternative remedy to a conventional derivative suit, an action in equity when the cause of action is primarily on behalf of the corporation against the board of directors for wrongful dealing with the corporate property. (See *Winegand v. Atlantic Savings and Loan,* 1 Cal.3d 806, 818-819; *Reed v. Norman,* 152 Cal. App.2d 892, 898; Pomeroy, Equity Jurisdiction (5th ed.) § 1095.)

Denes. They were directors and officers thereof and dominant in its operations when they had Custom investing. Although Goodson and Hannam's investment was comparatively small in contrast with what became that of Custom (about 5 percent as compared to 70 percent), the trial court position may be justified on the approach that, at first, in light of the Denes enterprise being essentially an unknown quantity,[82] the Custom commitments were calculated by Goodson and Hannam to insure the value of their personal investment and a prolonged receipt of substantial salaries. This may have been enough for accountability.

The trial court probably would have been justified in taking the view point, as its findings suggest it did, that Goodson and Hannam acted despite the fact that any reasonable person would have had a great concern as to whether Denes would develop a profitable operation and be able to repay advances.

However, more serious involvement developed which [illegible] firmer support to the ruling of the trial court. The circumstance evolved that Denes began to flounder financially threatening Goodson and Hannam's personal investment (and those of their client May and of some associates in their law firm, who in the meantime had acquired stock) and Goodson and Hannam's chances for lucrative salaries. The inference was available to the trial court that Goodson and Hannam caused Custom to pump more of its assets into Denes in an effort, in part, to rescue their own funds and positions. It is noteworthy that some of the loans to Denes were made after April 1966 when Keatinge made the overture to Goodson and Hannam on Davis' behalf. It also appears to be accepted that Denes was the only business to which Custom made loans. Finally, it is noted that no disclosure was made to Davis when the Denes stock purchases and loans were made.

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[82] The testimony of Goodson and Hannam indicated the Denes group had not taken formal shape. May testified that he knew that Denes had not been in business long and was not in good financial shape.

The theory of recovery is that the wrongdoing officer-director should be responsible for the misapplication of corporate funds. The basis for giving personal recovery to Davis in a proportionate amount was previously discussed.

This segment of the judgment is also sustainable as a remedy for the violation by Goodson and Hannam of the high fiduciary obligation owed to Davis arising under the attorney and client relationship. The violation consisted of Goodson and Hannam's repudiation of their assurance to Davis that they would operate Custom in a manner calculated to aid the current functioning of the Custom Plan and to conserve its assets[40] and pointed to a disposition in the distant future under a windup-reverter operation. The trial court was entitled to view the heavy Denes investment as not supportive of a Davis oriented Custom Plan, but rather as a move to enhance the personal and adverse interests of Goodson and Hannam. It seems more than a coincidence that Goodson and Hannam's action put a very substantial amount of assets one step further removed from accessibility to Davis. Davis, under this theory, would have a personal right of recovery from Goodson and Hannam in the nature of indemnity for any loss he suffered because of their breach of professional duty to him.

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[40] Even May testified that the intention of Goodson and Hannam and himself was to let profits accumulate and for Goodson and Hannam to receive minimal salaries.

(*Redke v. Silvertrust*, *supra*, 6 Cal.3d 94, 100-101.) The appropriate measure of damages would be in the diminution of Davis' equity position in Custom, as constructive owner of 60 ⅔ percent of its shares by reason of the amount of funds lost by Custom in this venture.

The provision in the judgment for credit for 60 2/3 percent of any payments received by Custom from Potter-Englewood, of course, remains applicable.

DAVIS' APPEAL AGAINST MAY

Davis appeals because the judgment did not impose a constructive trust for his benefit on May's Custom stock. The claim appears to be that May, through his Custom stock, became the transferee of trust property with constructive knowledge that the transfer was in breach of the trust or without giving any consideration therefor. In this instance, when Davis refers to trust property, he is not speaking about Custom stock. He must be alluding to things of value transferred by Davis (as himself or as Hydra) to Custom which he feels are traceable to the present equity interest in Custom which the 60 percent block stands for. Under the decision of the trial court there is just no logical basis for this contention. The Davis property referred to was never considered the subject of a trust. The only trust declared was a constructive one in rectification of a violation of an attorney's duty to his client and of which Goodson and Hannam's Custom stock was the corpus. Davis may have in mind that the attorney-client relationship is considered to be one of the trust relationships under Civil Code sections 2224 and 2243, but there was no corpus of that trust until Goodson and Hannam's stock became that in a sense when the trial court imposed a constructive trust thereon as the appropriate consequence to Goodson and Hannam's breach of duty.

Although May affirmed that Goodson and Hannam had told him that Custom was needed to solve Davis' renegotiation problem, that Davis was going to provide the so-called start-up help, and that they were going to control and run Custom, this does not mean that he should have known of Goodson and Hannam's fraudulent intentions. Nor can May have been expected to appreciate the full nature and extent of the attorney's fiduciary duty to his client and what would amount to a breach thereof so that his association with awareness of Goodson ahd Hannam's conflicts of interest and some of their moves seemingly antagonistic to Davis' interests would involve him vicariously in the breach of trust. It might have been different had May been a lawyer. Nor was May's affiliation with Goodson and Hannam equivalent to that of the wife in *Atwood v. Elwood*, 132 Cal.App.2d 761, 767.

INTERVENER'S PATENT ATTACK

Interveners contend that the trial court erred in foreclosing them, on behalf of Custom, from attacking the validity of the patent. They made an extensive offer of proof that the switch patent was invalid for a number of stated reasons. As we understand it, the offer does not relate to the other patents, no doubt because at suit time only the switch patent had any Custom production related to it. Interveners base their position on the case of *Lear v. Atkins*, 395 U.S. 653, 669-671 (overruling the part of *Automatic Radio v. Hazeltine*, 339 U.S. 827, supporting the doctrine of implied estoppel of a licensee to attack the validity of the licensed patent). The indicated part of *Lear* stands for the proposition that as between the typical patent licensor and licensee, where the patent has issued at the time of licensing, the licensee is not estopped to attack the validity of the patent and is not required to pay royalties while he is doing so under the concept that there is an express or implied agreement that royalties are to be paid until such time as the patent is held invalid.[64]

We have concluded that the trial court was correct in its determination that *Lear* does not govern the instant situation. We do not believe that Custom's disentitlement to get out of its royalty obligation arises simply because it was a patent licensee under the old *Automatic Radio* doctrine. Preliminarily we observe, as we did previously, that the assignment transaction must be viewed as single in substance though trifurcated in form. After the constructive trust ruling of the trial court (which we are upholding), only the minority shareholders had the interest which would prompt action to have Custom present a *Lear* defense against the payment of royalties. There was no longer a four-square adversity between Davis and Custom. Moreover, it is significant that the Davis invention had already been licensed to Hydra which had developed the technique and know-how of producing products from it for industry. (Contractors to the government at that time.) From the standpoint of this aspect of the case, by implication, not only were the assignment of the patent interest and the headstart advantage inherent therein consideration for the royalty obligation, but so also was the furnishing by Davis to Custom of technical materials, scientific brain power, and production know-how (a recognized class of industrial property independent of a patent). Involved in the latter is the further headstart for the assignee of not having to develop such techniques itself and the cost of such development. (See Adelman, *An Anti-Trust Decision: Lear v. Atkins* (Jan. 1972) 58 A.B.A.J. 45-47, and Schneider, *Protecting Trade Secrets* (January/February 1972) Trial, pp. 55-57.)

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[64] We are not concerned with the other segment of *Lear* which considers the problem there involved of the licensee's use for several years of the device ultimately patented as constituting a basis for resisting the payment of post patent royalties by attacking the validity of the patent. This is because the patent in our case issued practically contemporaneously with the assignment of the patent interest to Custom.

Further Custom, the patent assignee, was formed specifically to be the assignee as a part of the Custom Plan for Davis' particular and personal reasons. There was no arms-length bargaining process between Davis and Custom. The value of an undivided one-half interest in Davis' patent was immaterial. Custom, essentially, was just a vehicle for the Custom Plan to save Hydra from renegotiation and to bring Davis capital gain income, as devised by Goodson and Hannam and as expressly recognized by May, and impliedly so, by the employee shareholders.[85] There was no implied representation of the validity of the patent, but Custom was to perform all lawful acts to sustain it as against third parties. As long as the governmental agencies were satisfied, the assignment met the purposes of the Custom Plan.[86] The record suggests that the minority shareholders had the mental approach that there was available for them the opportunity to be profiting out of the scheme devised by Goodson and Hannam to aid their client, Davis; i.e., out of the functions of Custom as it implemented that scheme. Custom and its minority shareholders were in the position more of lacking standing to assert patent invalidity than of being estopped to do so.

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[85] There is no finding they did not. The only finding is that the minority shareholders acquired their stock without any notice of Davis' claim of right to a constructive trust and without any participation in or knowledge of Goodson and Hannam's professional derelictions.

[86] If, along the line, the government should have taken the position adverse to Davis and told him, because it felt that his patent was invalid, that it was going to consider that his royal-

(This footnote is continued on next page)

Finally, and perhaps decisively on its own, in order for Custom to avoid its obligation to pay royalties to Davis, as its obligation was originally understood and as the contract has been interpreted by the court,[67] Custom (through the minority shareholders) would have to attack and establish the invalidity of all the patents to erase its royalty obligation, because royalty payments remain due as long as any one patent or improvement patent, even though narrowed in scope, remains effective, regardless of whether Custom is utilizng that one in its production (under the *Zenith-Automatic Radio* concept), as previously indicated.

SPECIAL APPEALS

There is an appeal by the minority shareholders from that part of the order of June 4 ,1970, which says that no more attorneys' fees are to be paid from funds of Custom. They term this a protective appeal. It is questionable if the order was separately appealable. Anyway we consider it reviewable under the appeal from the judgment. The issue is met and resolved by

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ties were ordinary income and that Hydra and Custom were under common control, that might have meant that the reason for Custom and its operations had come to an end. Custom's dissolution, subject to fair treatment to the minority shareholders, might then have been in order.

[67] Meaning by the trial court to the extent affirmed by us.

our discussion on the main appeals. The order was sound as it related to the personal defenses of the minority shareholders. However, it should not now be considered appliable to the interveners to the extent that they should be permitted to obtain corporate assets to cover any fees allowed by the trial court to cover services in the limited areas indicated. The appeals from the order should be dismissed.

There is an appeal by the minority shareholders from the order of October 29, 1970, requiring them to withdraw a "Petition for Arrangment in Matter of Custom # 90764" under section 321 of the Bankruptcy Act. At least the notice of this appeal is part of the clerk's transcript. We are not sure whether it was intended that this be put before us. In any event, it is not pursued, so we do not treat with it. (*Title G. & T. Co. v. Fraternal Finance Co.*, 220 Cal. 362, 363; *Weiss v. Brentwood Sav. & Loan Assn.*, 4 Cal.App.3d 738, 746; *Southern Cal. Title Clearing Co. v. Laws*, 2 Cal.App. 3d 586, 591.)

INTEREST

Interveners have raised the question of whether interest should have been allowed on the components of the royalty judgment against Custom. As premised on the 100 percent royalty base, the interest award probably was correct (*Esgro Central, Inc. v. General Ins. Co. of America*, 20 Cal.App.3d 1054, 1060-1061), but further determinations must be made at the trial level from the nature of which a decision on interest will be made. Thus it is premature for this court to make any pronouncement on the issue.

DISPOSITION

In order to effectuate our holdings and to allow trial court reconsideration of the matters subject to remand the various segments of the judgment are affirmed and reversed (6 Witkin, Cal. Procedure (2d ed. 1971) Appeal, § 557, p. 4497) as follows:

Paragraph 1 of the judgment (impressing the constructive trust) is affirmed.

Paragraph 2 of the judgment (adjudicating Custom's royalty indebtedness to Davis) is reversed.

Paragraph 3 of the judgment (adjudicating Goodson and Hannam's indebtedness to Davis less offsets) is reversed.

Paragraph 4 of the judgment is affirmed.

Of Paragraph 5 of the judgment the following subparagraphs are reversed: (a), (b), (c), (d) and (h). There shall be struck from subparagraph (f), where it twice appears, the phrase: "based on 100% of its gross sales revenues or net profits (as the case may be)." As so altered, subparagraph (f) is affirmed. All other parts of paragraph 5 are affirmed.

To the extent that Paragraph 6 of the judgment decrees that the Custom stock standing of record in the name of Goodson and Hannam shall belong to Davis free and clear of any claims of Goodson and Hannam, it is affirmed; in all other respects Paragraph 6 is reversed.

Paragraph 7 of the judgment is reversed.

Paragraph 8 of the judgment is reversed.

Paragraph 9 of the judgment is reversed.

Paragraphs 10 and 11 of the judgment are affirmed.

Insofar as the judgment makes no provision for payment of some amount of attorneys' fees for interveners from the assets of Custom, it is reversed.

The trial court is directed to conduct further proceedings consistent with this opinion.

The appeals from the order of June 4, 1970, are dismissed.

The order for withdrawal of Petition for Arrangement is affirmed.

Davis is entitled to costs on appeal as against Goodson and Hannam.

May, in his individual capacity, is entitled to costs on appeal as against Davis.

All other parties, in whatever capacity, shall bear their own costs on appeal.

NOT FOR PUBLICATION.

Reppy, *J.*

We concur:

Aiso, *Acting P. J.*
Dunn, *J.*